TAKOTA
Asset Management Inc.

Reflections

Partners in Capital Growth

January 2019

"Avoiding overpriced speculations and maintaining a strict value discipline are more important than ever because the over-pricings are so egregious and the bargains so pronounced.

Yet the price swings are so severe and swift, and not always in the desired direction, that investors must be braced for mark to market losses.

Those sufficiently disciplined and unwavering will be generously rewarded."

Seth Klarman

Process is more important than ever

All the past year we had been waiting for share prices to finally reflect the physical reality of the underlying business they represent given in some case the continuing improvement and in others the excessive optimism in that physical reality. At year end we found ourselves not only still waiting but also having to witness a general market correction primarily precipitated by the U.S. administration.

In my experience when the market corrects one of two things happens with the smaller less liquid esoteric type companies that we favour:

- either market participants pass right over them in their desire to find liquidity and their prices are left pretty much unscathed, OR
- relatively small selling has a big impact on their prices (especially if insiders hold most of the stock).

I have seen both. I recall owning stocks like Loewen Group that didn't flinch at all in the so called "Black Monday" market correction of October, 1987. But in 2018 we mostly saw the latter - perhaps because the corrective action has been less acute and dragged on.

It is an often-quoted fact that if a security falls by say 50% in price, it requires a subsequent 100% gain in order to simply break even.

If the mark-down is market-related rather than due to adverse company news, an investor selling such a security at that time adds a new risk to his capital: the marked-down security has to be replaced by another security with +100% potential in order to break even.

In trying to do so and given the magnitude of the challenge, this investor will often be tempted to gamble on what is currently said to be the "most attractive" or "most promising" investments – unfortunately investments usually already over-priced.

This could well add a second risk: a security purchased at a price above its intrinsic or business value may never recover to that market price.

Proper value investing is what mitigates this second risk: if a value investor calculates that the fair value of a business is $8-10 per share and he is able to buy that business at $5 per share, a subsequent market-related decline in price to $2.50 would mean two things: 1) that it is almost certainly temporary- as long as the value of the business remains well above its market price, and 2) that it is a wonderful opportunity to buy more of that bargain at this further discounted price. Remember that business value, based in physical reality, generally fluctuates to a much lesser degree than does market pricing.

We read a lot about the length of the current business cycle, and while in stock market terms it has been a long and positive cycle for investors it has been so only in the U.S. market. The Canadian market has barely participated other than for a few U.S. style investments available in the Canadian market and for those historically great mis-allocators of capital, the Canadian banks.

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As I have previously said, given my experience through several business cycles, it would be "normal" to see a reversion-to-the-mean type of trade before this cycle ends, where the current under-performance of the TSX against US indices is corrected, which would logically come together through a broad participation of mid and late cycle components - heavily represented in the Canadian market.

These types of securities (which include energy and mining) began to rally from depression-like lows in 2016 and in to 2017, but have corrected back to those lows or in some cases even lower, despite improving physical realities. Given that the market prices of these companies are oh so low, they seem to only have one way to go - up!

Our choices are primarily oriented toward those situations for which there is an overriding secular growth story which will carry on through this and subsequent business cycles. In other words, if GNP[1] is composed of different "buckets", some growing and some contracting - our investments tend to be in those "buckets" that are a growing part of GNP.

Furthermore, investors do not face the same pricing risks related to the maturity of the business cycle as they did in say 2007 because materials investments are already on the floor mat. Unlike 2007, they do not reflect any form of euphoria whatsoever. In fact, quite the opposite.

I therefore continue to believe in one basic idea as it pertains to investing for (eventual) capital growth.

This simple idea supersedes all other factors, macro-economic and otherwise. The idea is that if one can buy really good companies at a good price (usually during a market correction or temporary problem) and/or if one can buy ok companies or assets (cyclical companies for example) at an unbelievably cheap price (usually at the bottom of the cycle), that over time good things will happen.

Supplementing this principal activity with a hedge in the form of a short position or other instrument offers incremental return (or volatility reducing) possibilities, when appropriate and available.

To paraphrase one of our favourite studies, "What Has Worked in Investing" by Tweedy Browne, the five main determinants of superior rates of return are:

1. A low price relative to asset value,
2. A low price relative to earnings (cash flow),
3. A significant pattern of purchases by one or more insiders,
4. A significant decline in a stock's price, and
5. Stocks with smaller market capitalization.

Those are the characteristics we have in spades in our portfolios – we just need to have the patience to see them mature.

As always, please call if you have any questions.

Scott Leckie, CFA

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[1] Gross national product (GNP) is the value of all finished goods and services produced in a country in one year.