July 2016

A Firmer Quarter

An assessment of the current market

While deep value investing (the strategy we employ) continues to be out of favour relative to other currently popular approaches to managing investments, business developments in our Portfolios point to higher values as companies adapt to the new normal.

We acknowledge that strategies that for decades had underperformed compared to deep value investing have outperformed it in the past several years. However, most of these strategies have not been tested through time like deep value investing has, and I fully expect to see them revert to the mean, i.e. to their previous performance level. One is reminded of the so called Nifty Fifty[1] growth stocks of the 1970's: a group of stocks whose future growth was supposed to be so strong that it was deemed to be a sure bet to simply buy them and hold them forever. This proved rather costly.

Today investors are attracted to many of the same type of companies as in the 70s'. The Nifty Fifty were large capitalization consumer product and technology companies; their descendants today are also consumer product companies, together with large capitalization internet and social media companies.

Away from such currently high flying stocks, we readily acknowledge investors' concern for depressed prices in other sectors of the market, such as mining, materials and energy - but it is in those sectors that we continue to see a very large gap between current market price and the value to be realized in any kind of normalized scenario for economic growth.

Of course, for a given low price any possible investment could be a good investment or a poor investment. This is where evaluation and selection skill and experience come in.

Our current experience in our portfolios is of corporations taking actions to increase the safety of their balance sheets due to the continuation of weaker materials prices while others only await a change in market sentiment or the actions of corporate buyers (or activists) to have their share prices reflect their growth and general positive fundamentals. In the meantime and while waiting for better prices, distributions and realizations provide liquidity, allowing further investments at still (very) low prices. The rest is a question of patience – in this cycle, a significant amount of patience, but this is historically well rewarded.

On market statistics

We have recently read some interesting statistics about the significant length of time top quartile performers spend in the bottom quartile. Our own historical experience perhaps gave us a false sense that we were free from such gravitational pull - as for some 20 years we seldom deviated from top quartile performance, but in this cycle we seem to have been paying our dues for this angelic past. Nothing is permanent…

However, “nothing is permanent” works both ways. Markets will turn again and the gap between price and value will close. Deep value portfolios will rotate to the next set of opportunities while the opportunities that we see now, chosen for the type of environment we are now in – will in all likelihood provide more significant returns that the current Nifty Fifty will have.

We expect that when the market turns the extent of the recovery from our currently extremely low prices will surprise many. As Portfolio Manager I am well aware of the lesson I learned in the early 1990's, when frustrated and under pressure for some languishing stock positions, I sold them after they recovered and had appreciated by some 50% only to see them go up to multiples of their original cost as the next cycle took hold. This is where our experience and our further refined value framework for making sell decisions should help maximize returns.

W. Scott Leckie, CFA

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[1] American Home Products, AMP Inc., Anheuser-Busch, Avon Products, Baxter International, Black & Decker, Bristol-Myers, Burroughs Corporation, Chesebrough-Ponds, The Coca-Cola Company, Digital Equipment Corporation, Dow Chemical, Eastman Kodak, Eli Lilly and Company, Emery Air Freight, First National City Bank, General Electric, Gillette, Halliburton, IBM, International Flavors and Fragrances, International Telephone and Telegraph, Johnson & Johnson, Louisiana Land & Exploration, Lubrizol, Minnesota Mining and Manufacturing (3M), McDonald's, Merck & Co., MGIC Investment Corporation, PepsiCo, Pfizer, Philip Morris Cos., Polaroid, Procter & Gamble, Revlon, Schering Plough, Joseph Schlitz Brewing Company, Schlumberger, Sears, Roebuck and Company, Simplicity Pattern, Squibb, S.S. Kresge, Texas Instruments, Upjohn, The Walt Disney Company, Walmart, Xerox.