TAKOTA
Asset Management Inc.

# Reflections

Partners in Capital Growth

**April 2018**

## Changing Market Leadership

**First Quarter 2018**

The first quarter of 2018 was marked by weak markets and increased volatility. Volatility is typical of a market whose leadership is changing which I believe is what is happening now. Doubts are mounting about the pricing of the companies that were the darlings of investors over the last few years. This translates into price weakness for these companies, but also into reinvestments into the solid if less flashy and smaller companies that had been neglected for too long for being in the “wrong sectors”.

I had expected that following the positive 2017 year-end we had and the news and developments that have started to flow, or are about to flow into sectors that we are involved with, that we would break the seasonal pattern of the past several years, i.e. a weak beginning to the year followed by strengthening throughout the balance of the year.

But this was not to be. In the first quarter of 2018 the TSX was the second worst performing market in the developed world (after Switzerland). It is likely to reverse course however, as things do tend to revert to the mean.

None the less, I still expect strong results for the year. As the market cycle evolves, we see the fundamental developments that are occurring especially in companies that have been under-appreciated for too long starting to be recognized. While no two market cycles are the same, history does rhyme and while I'm not a market prognosticator I have been around for a few market cycles. I see now the sort of market condition I experienced in 1987 through 1990, namely a maturing business cycle with the beneficiaries being economically sensitive businesses and commodity producers.

I am not positive on the US market, on the Canadian domestic market including real estate, on big technology, marijuana, or cryptocurrency.

On the other hand the developed world is aging and its growth is slowing, making exposure to healthcare and seniors housing examples of what could be interesting.

In the developing world, such as in Indonesia, India, etc., interesting areas are first those companies that produce the basic materials for the development of modern infrastructure followed by, once the need for basic materials is met, consumer products – as is currently occurring in China.

**How to invest in this turnaround**

Today, as I look at our portfolios (which as always are a collection of out-of-favour, abandoned, or simply undiscovered securities) I can make the following observations:

1. By design, we prefer to build our portfolios with the types of securities that have been shown to produce superior rates of return historically, such as:

- securities that are "cheap" by various fundamental metrics outperform because of the concept of "reversion to the mean";

- securities that are smaller in market capitalization because fewer "eyes" watch them and therefore they tend to fall through the cracks and therefore to be mispriced.

Finding mispriced securities is the value-add that an active investment process should provide (see "What Has Worked in Investing" - Tweedy Browne[1] for an extensive elaboration of these ideas).

2. A consequence of choosing such securities is that they can be more volatile than the market as a whole. They are what is called in technical jargon “high beta securities”.

Beta is a backward-looking measure of the historic volatility of a security compared to the volatility of “the market". For example, if a security has a historical beta of 3 and the market decreases by 1%, one would expect that security to decline by 3% - *as it has done in the past*. We are not talking here about changes in company values, but rather simply price changes due to market gyrations.

3. Furthermore, when securities have a large potential for appreciation given their current under-evaluation it can make sense to take – again by design- large (“concentrated”) positions. Added to the high beta characteristic of such securities, one can see how it is reasonable to expect that absent fundamental news/developments portfolios built in this fashion are likely to be more volatile than the market.

[1]tweedy.com/resources/library_docs/papers/WhatHasWorkedFundOct14Web.pdf

4. The solution to weather volatility is not to plan for or worry about particular levels of volatility because volatility (day-to-day market movements) reflects only these market movements and not actual developments affecting the underlying assets and is therefore not a risk to the invested capital. This requires that investors be patient enough to wait for the estimated under-pricing of each security to be recognized in time by the market and corrected.

In our case and like most value minded investors, we define risk as the risk of permanent impairment of capital, and see market volatility as just a (alas often unpleasant) nuisance that has to be tolerated to achieve our goals.

We therefore view our portfolios as a concentrated collection of discoveries, each with tremendous capital appreciation potential as mentioned above. As securities mature toward their fair value, their volatility tends to decrease. Once sold, as they are progressively replaced by a new of opportunities, the level of volatility of the portfolio will change again.

As always, please call if you have any questions.

Scott Leckie, CFA

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