Winter 2018

"… is not a year I shall look back on with undiluted pleasure… it has turned out to be an Annus Horribilis."

~ Queen Elizabeth II, 1992

2017 was not fun! Our portfolios declined slightly from the prior year's strong performance. Posting a negative performance, even a small quotational one, is never pleasant. This is especially true when major indices post positive returns. The perfect storm happened to make 2017 an "Annus Horribilis":

- Our energy holdings dropped from their 2016 year end closing prices;
- The Canadian dollar appreciated relative to the U.S. dollar; hurting the value of our U.S. investments;
- Our non-energy holdings positive returns were not enough to offset the decline in our energy share values;
- Our large Government of Canada T-Bill balances earned very little;
- Automated trading strategies based on both price and fundamental momentum, indiscriminately drove out of favour value stocks substantially below previous discounts to intrinsic value;
- Global equity markets continued their rise into ever higher and riskier levels of valuation;

Despite the results we remain confident. Our confidence is based on three fundamental factors. First, we believe that the companies in our portfolios were purchased at substantial discounts to their intrinsic value. Over time, the market values assets at their true worth and as a result, despite price fluctuations, our holdings should realize a positive return. Secondly, the underlying fundamentals of all our investee businesses are improving and, generally, exceeding expectations. Share prices eventually follow fundamentals and value. Finally, our significant cash balances provide a store of value and a safe harbour as we wait for opportunities to materialize.

When we founded PCM in March of 2000 we promised that we would not stray from our investment philosophy based on long term absolute value. We stated that we would only buy securities that met our criteria for quality and safety and offered a potential compound annual return of twenty per cent over a long period of time. And that is exactly what we have done.

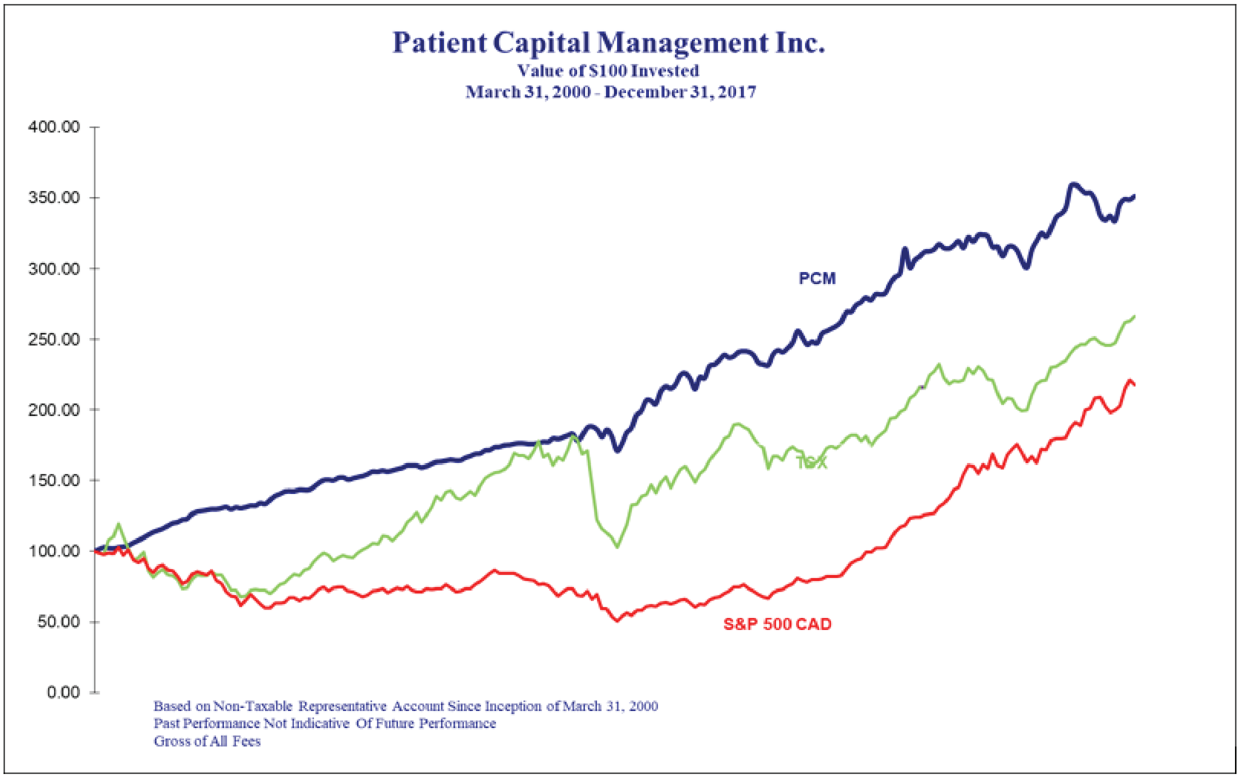
While there are no guarantees, it is our very strong belief that our current portfolio of stock selections has the potential to experience similar returns in the future.[1]

PCM Investments Bought and Sold Since Inception

Company	Ticker	Avg.	Date Bought		Date Sold		Sell Price	Holding	Gross	Ann'lz'd
		Cost	Year	Month	Year	Month		Period	Return	Return
Securities Sold										**(Ex. Div)**
Ambassadors Int'l	AMIE-O	$ 14.02	2001	10	2001	12	$ 20.52	2	46.36%	**883.05%**
Lowes	LOW-N	$ 19.98	2008	7	2008	9	$ 26.00	2	30.13%	**385.59%**
National Oilwell Varco	NOV-N	$ 33.70	2010	6	2010	11	$ 62.29	5	84.80%	**336.62%**
Spar Aerospace	SPZ-T	$ 8.39	2000	12	2001	7	$ 17.45	7	107.99%	**250.91%**
Northbridge	NB-T	$ 27.00	2008	9	2009	1	$ 39.00	4	44.46%	**201.47%**
Cameco	CCO-T	$ 17.99	2000	3	2001	2	$ 30.25	11	68.20%	**76.34%**
Nokia	NOK-N	$ 10.97	2004	8	2006	6	$ 30.30	22	176.22%	**74.05%**
West Fraser	WFC-T	$ 27.29	2007	11	2008	5	$ 35.57	6	30.37%	**69.98%**
Corning	GLW-N	$ 11.08	2012	8	2014	5	**$ 22.15**	21	99.91%	**48.56%**
Alcan	AL-T	$ 37.17	2005	3	2006	2	$ 53.06	11	42.78%	**47.47%**
Qualcomm Iinc.	QCOM.O	$ 54.38	2015	12	2017	10	**$ 70.64**	22	29.90%	**15.34%**
Berkshire Hathaway	BRK.B-N	$ 66.80	2011	9	2013	2	$ 100.43	17	50.34%	**33.35%**
Franco-Nevada	FNV-T	$ 16.24	2000	3	2001	11	$ 25.00	20	53.94%	**29.54%**
CCL Industries	CCL'B-T	$ 19.99	2009	8	2012	2	$ 35.40	30	77.09%	**25.68%**
Cogeco Cable	CCA-T	$ 11.89	2002	6	2005	11	$ 25.70	41	116.08%	**25.29%**
Norske-Scog	NS.A-T	$ 16.75	2000	9	2001	4	$ 19.00	7	13.43%	**24.12%**
BCE	BCE-T	$ 22.41	2008	11	2010	12	$ 35.03	25	56.33%	**23.92%**
CBS	CBS-N	$ 10.80	2008	10	2010	9	$ 16.00	23	48.18%	**22.77%**
J.P. Morgan	JPM.N	$ 34.93	2012	8	2016	10	$ 80.00	50	129.03%	**22.00%**
Connors Brothers	CBF.UN-T	$ 11.33	2001	11	2004	3	$ 17.75	28	56.69%	**21.22%**
Barrick Gold	ABX-T	$ 22.61	2003	5	2006	8	$ 36.23	39	60.24%	**15.61%**
Diageo	DEO-N	$ 56.63	2008	10	2012	1	$ 90.64	39	60.07%	**15.58%**
Cisco Systems	CSCO-O	$ 16.38	2011	6	2014	5	$ 24.80	35	51.38%	**15.27%**
Canadian Apt. REIT	CAR.UN-T	$ 11.51	2000	11	2002	3	$ 13.85	16	20.33%	**14.89%**
Wellpoint	WLP-N	$ 48.15	2008	3	2014	3	$ 115.75	72	140.38%	**15.74%**
Kohl's Corp.	KSS-N	$ 45.69	2011	9	2015	3	$ 70.00	42	53.21%	**12.96%**
Inmet Convertible	IMN-T	$ 63.50	2001	4	2005	1	$ 100.00	45	57.48%	**12.87%**
Mercury	MCY-N	$ 34.82	2008	3	2010	6	$ 42.92	27	23.26%	**9.74%**
Magna	MG.A-T	$ 63.89	2003	5	2007	4	$ 88.92	47	39.17%	**8.80%**
US Bancorp.	USB-N	$ 25.81	2008	7	2012	8	$ 32.00	49	23.99%	**5.41%**
Dorel Industries	DIIb.TO	$ 24.26	2005	12	2015	4	$ 36.00	112	48.42%	**4.32%**
Pfizer	PFE-N	$ 21.80	2005	12	2013	3	$ 28.09	87	28.85%	**3.56%**
Wells Fargo	WFC-N	$ 25.42	2008	1	2008	11	$ 26.06	10	2.52%	**3.03%**
Chorus Aviation	CHR'B-T	$ 6.72	2007	4	2013	3	$ 2.75	71	-59.08%	**-14.02%**
Nokia	NOK-N	$ 10.93	2008	10	2013	10	$ 3.75	60	-65.70%	**-19.27%**
										22.14%

[1] Based on Representative Account Since Inception
Before all Fees
Past Returns Not Indicative of Future Returns
Average Annualized Return Excludes Returns Above 100%

The chart below shows our performance since inception. As you can see, PCM has outperformed the major North American indices since inception; notwithstanding being holding very large cash balances over this time frame.



One hundred dollars invested with us as of March 31, 2000 would be worth $351.39[2] vs. $266.32 for the TSX and $217.59 for the S & P in Canadian dollars. In addition, the returns have been far less volatile than the general equity markets.

For those of you who have become PCM clients more recently, your returns have not had a similar experience yet. You can rest assured that almost all of our long term clients started out with similar results. However, we believe and the evidence presented above suggests that over a "full cycle" all of our clients will obtain very satisfactory returns with less risk.

[2] Based on Representative Account Since Inception
Before all Fees
Past Returns Not Indicative of Future Returns

Volatility is back!!

After several years of smooth and steady increases, equity markets provided a very small dose of realism over the past several weeks. Markets dropped on several days as investors became concerned about rising interest rates. While the headlines were quite dramatic, the declines were small in percentage terms and the markets quickly made up most of their losses. Given the extreme levels of overvaluation, these drops are not nearly enough to put companies that meet our standards for value and quality into our buy range.

The recent market volatility highlights the risk posed by the rush into passive investments and automated trading strategies. These strategies are very similar to the elements that resulted in 1987's market crash. Back then, institutional investors believed that they each had a proprietary computerized system that would automatically get them out of the market once it started to go down. What they didn't realize was that everybody else had a similar program. When the market turned negative, all of the programs were activated at the same time. It was like a herd of elephants trying to get through a very small door. The result was Black Monday; a one day drop in equity prices of 25%.

Today's passive investment and automated strategies have the potential to cause such an event again. The difference this time is that the dollars are substantially larger and the computers faster and more powerful. Should an exogenous event such as a political or geopolitical crisis materialize, these strategies and/or programs could be the "accelerant on the fire".

We would welcome this scenario! It would allow us to deploy our capital into very attractive investment opportunities and set us up for substantial long term rates of return.

Today, value investing is extremely out of favour. As the chart below indicates, value investing has underperformed growth investing over the past ten years. Investors have shown a strong preference for companies that are increasing sales at a rapid pace irrespective of profitability and valuation. Slower growing companies trading below their intrinsic value have largely been ignored. The global decline in interest rates, combined with the aforementioned wave of essentially momentum based passive investments and computerized trading have been the largest contributors to this underperformance.

Consequently, many value managers' businesses have suffered as clients have migrated to better performing products. In response, many of these managers have altered their investment strategies. Others have deviated from their style while using "intellectual gymnastics" to justify the purchase of companies such as Netflix and Amazon. Benjamin Graham, the father of value investing, would be shocked at the redefinition of his cherished principles.

Another tactic used by some value managers to gather assets, has been to offer a portfolio of high quality companies that have a dividend yield that is higher than current interest rates. The relative value of equities over bonds is touted without mentioning the fact that these companies are trading substantially above long term multiples. The attractive characteristics of the businesses are also highlighted as a reason for a safe investment. After all, how risky is it to invest in household names such as Coca-Cola, Pepsi, and Colgate to name a few. It's a feel good story that is easy to sell; especially to those in need of income.

Be very careful!! These portfolios are subject to substantial capital loss should these companies trade back to their historical multiples. It will take several years of earnings and dividend growth to offset the loss of capital.

Let me illustrate. Today, these portfolios typically have a weighted price/earnings ratio in the range of 25x and a dividend yield of approximately three per cent. If and when, the portfolio's investee companies fall back to their historical average P/E of 15x, the result is a capital loss of 40%. Assuming five per cent growth in both earnings and dividends it will take approximately nine years just to break even!

At PCM we have promised that we would always act as fiduciaries first and foremost. Part and parcel of that promise is that we will never compromise our investment philosophy; no matter the business pressures. Virtually every successful long term investor that we have studied has followed a disciplined value based approach. Our results since inception indicate that our philosophy does indeed work over the long term.

To borrow Warren Buffet's recent quote from Rudyard Kipling's poem *If*:

"If you can keep your head when all about you are losing theirs . . .

If you can wait and not be tired by waiting . . .

If you can think – and not make thoughts your aim . . .

If you can trust yourself when all men doubt you . . .

Yours is the Earth and everything that's in it."

Vito Maida

PCM

PCM

Patient Capital Management Inc.

100 Simcoe Street, Suite 100 Toronto, Ontario M5H 3G2