Winter 2019

"If you can keep your wits about you while all others are losing theirs and blaming you. The world will be yours and everything in it."

~ Rudyard Kipling

Our performance during 2018 was disappointing. While we outperformed the TSX, this was PCM's worst year of performance, since our inception. Consequently, our longer term returns have been impacted. Unlike our Prime Minister, who often claims to experience the same situation quite differently than others, I can assure you that we have had the same experience as all of you! As you are aware, we invest our capital alongside yours.

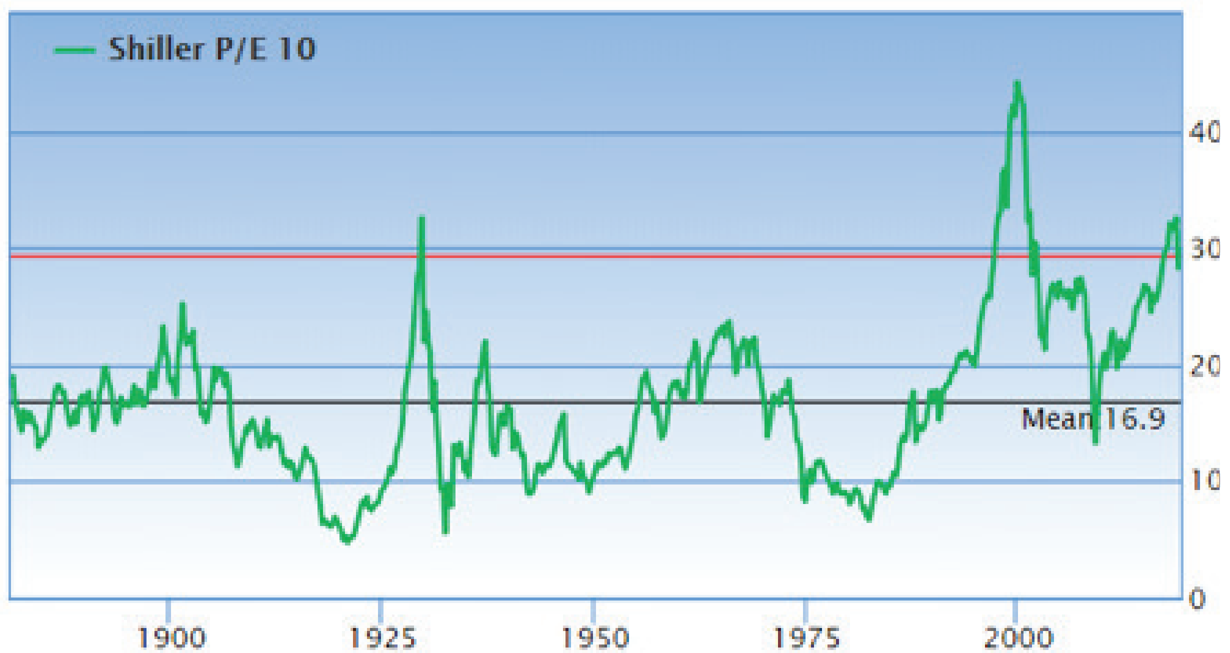
We have promised all of you that we would implement our investment philosophy without compromise; to only purchase high quality businesses at a substantial discount to their underlying value. If we could not find those investments we would invest the capital in very safe short term instruments. This strategy has historically proven to be the most effective approach in growing wealth while minimizing risk.

However, the past five years have not been kind to our strategy. The markets have not offered us the opportunity to find many investments that met our criteria and short term fixed income instruments have earned very little. To top it off, value investing has underperformed growth investing by the largest margin for the longest period of time in history. The following three charts summarize the challenging environment that we have been operating under.

Below is the Schiller P/E, a graph that we have often referred to. As illustrated, valuations are at one of the highest levels ever. Moreover, the overvaluation has persisted for a number of years.

Graph 1

Shiller P/E Ratio[1]



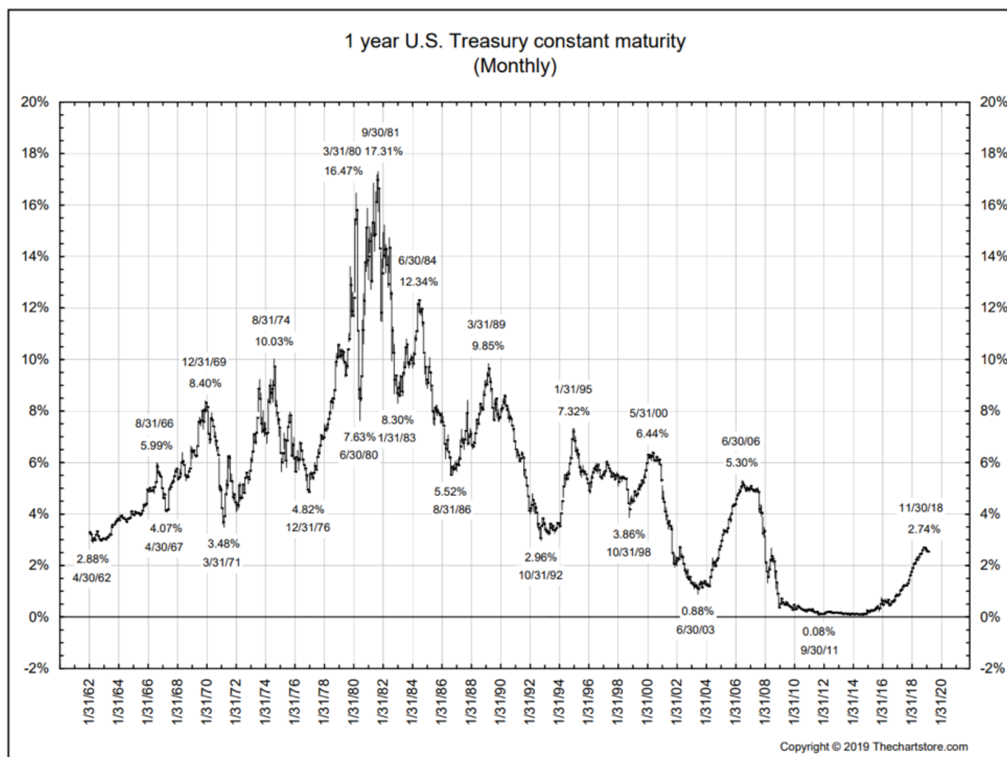
A rising tide lifts all boats. Companies that we are interested in have traded at fair value or higher for the better part of the last five years. As a result, we have had a tremendous amount of difficulty finding investments that meet our criteria.

This leads to our second challenge. Safe short term fixed income instruments have offered very low rates of interest for several years. Graph 2 below, puts in context how low and for how long these rates have persisted.

[1] Source: GuruFocus.com

Graph 2[2]

One Year U.S. Interest Rates



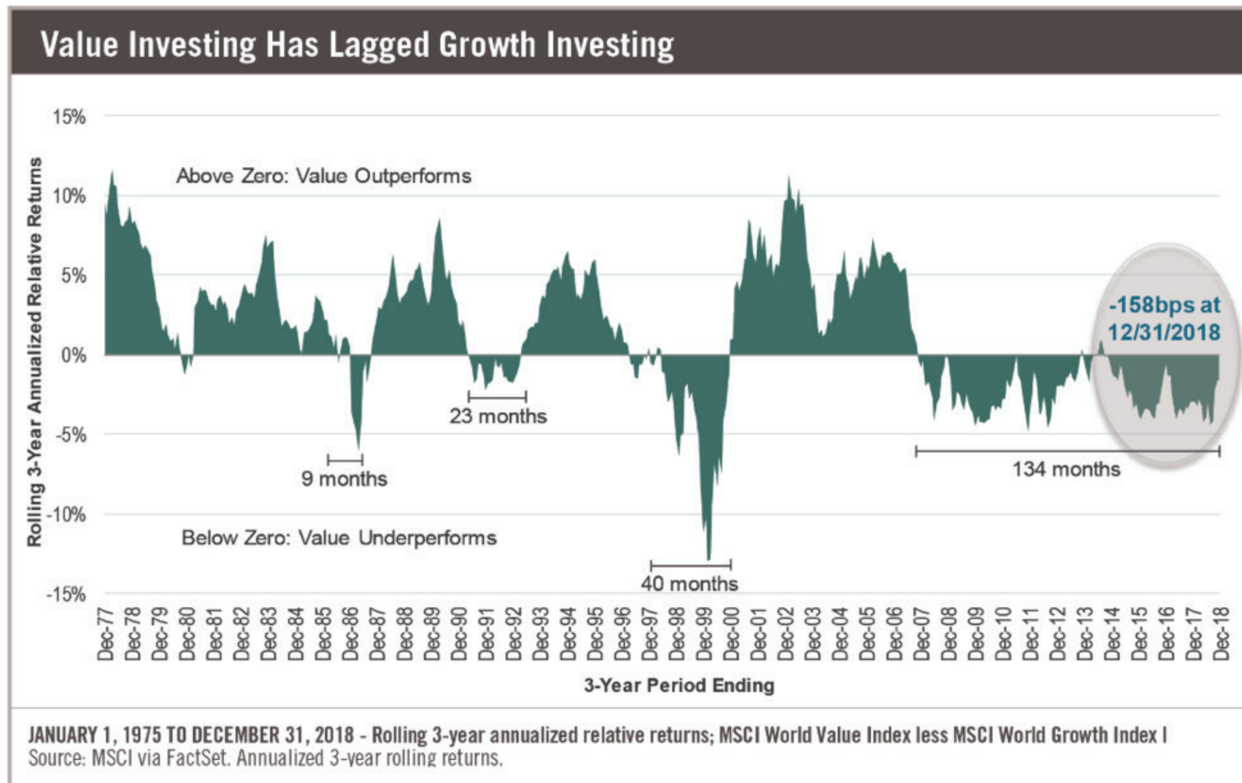
These artificially low interest rates in turn have had a serious impact on returns. Our very large T-Bill balances, have earned very little. It is like running a marathon on a treadmill; you're not getting anywhere. Nonetheless, we would prefer to earn very little rather than risk our "store of wealth" in the pursuit of higher but much riskier income streams.

To complement this perfect storm, value investing has dramatically underperformed growth investing and the broader indices. In a low interest environment, market participants are driven to chase returns in high revenue growth companies often at extraordinary valuations. The graph below clearly shows the performance gap between these two styles.

[2] Source: The Chartstore.com (https://www.thechartstore.com/system/files/2-19%20Monthly%201%20year.pdf

Graph 3

Value vs. Growth Returns[3]



As such, the past ten years have been difficult for value investors investing around the world. The chart shows that value has underperformed its growth counterpart for more than 130 months, the longest period on record.

Long term studies all suggest that value investing offers superior returns with substantially less risk. For the 90-year period between 1926 and 2016, value stocks returned 17% per year vs. 12.6% for growth stocks, according to Bank of America. Value stocks outperformed growth stocks 60% of the time during that period.[4] We don't believe in new paradigms, ultimately value wins out.

[3] Source: Valuewalk.com (https://www.brandes.com/us/advisors/brandes-quarterly-letter/)
[4] Source: https://www.valuewalk.com/2018/02/performance-differential-growth-stocks-value-stocks-now-greater- time-history/

To summarize, high valuations, low interest rates and an out-of-favour investment style have led us to our current state of affairs.

The pain of missing out is very real; especially when we compare ourselves to broad market returns. The TSX and S&P 500 have provided positive returns over the last three and five years. However, these returns have largely been concentrated in a small number of securities.

In Canada, the big five banks have contributed forty seven per cent of the TSX return over the past ten years.[5] During the past three and five years, the TSX return, excluding the banks, has been marginal at best. We have invested in the banks, but only when valuations have met our criteria and offered an appropriate return for the potential risk. Our purchase prices are made at very high historical yields and/or very low historical price-to- book values.

There is no doubt that the banking industry in Canada has many attractive characteristics, yet Canadian banks are not without risk. There has been the threat of a slowdown in the housing market and declining wealth management and capital earning streams for some time. While their dividends and capital positions are not at risk, their share prices can be subject to material declines, as we witnessed in 2008 and just recently.

In the United States a similar situation has occurred. A small group of stocks labelled, FANG, (Facebook, Amazon, Netflix, Google) have driven the aggregate market return. By some measures, over the past three years the FANG stocks, along with a few other technology stocks, like Microsoft and Apple, have contributed the vast majority of the S&P 500 total return. We simply would not have purchased these companies, either because of their underlying business models and/or their extreme valuations. Had we done so, you would have correctly concluded that we had breached our discipline and you should have taken your money away; irrespective of performance.

[5] Source: Globe and Mail
Saturday March 9th, 2019.

We believe that the future will be quite different than the past. During the market sell off last November and December we had the opportunity to purchase investments that met our criteria for value and quality. We added several new positions and are now at the highest level of investment that we have been in several years. These additions add three important attributes to your portfolios:

> The portfolio is more diversified in the number and types businesses that we own;
>
> The new investments have dividend yields that are substantially higher than the return being earned on T-Bills;
>
> Our new purchases all offer the potential for substantial capital appreciation.

As long as we maintain our discipline and find more opportunities like those described above, our collective wealth will grow.

I have been through these situations in the past. Patience can wear thin! At PCM we are blessed with a dedicated and unwavering team, wonderful supporters and a group of clients that is the envy of the industry.

To all of you I owe a large debt of gratitude!

Vito Maida

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