Fall 2015

***"In the short term the market is a voting machine.
In the long term the stock market is a weighing machine."***
~ Benjamin Graham, The Intelligent Investor

Equity investors finally experienced some reality this past quarter. After a considerable period of consistent gains, the TSX dropped 7.86% while the S & P 500 fell 6.69%. The sell-off was sharp enough to pull North American markets and the majority of global indices into negative territory for the year. The decline was sparked by concerns over deteriorating global economic growth as a result of the weakness in developing economies. As a result, growth expectations have been reduced to 3% from 3.5% and commodities continued their decline mirroring the negative outlook. Consequently, investors around the globe aggressively sold their holdings in resource based businesses. Canadian equity markets were particularly hard hit due to their exposure to natural resources and a weakening economy.

However, in October equity investors totally reversed course. They were buoyed by the fact that the Federal Reserve did not raise rates. The S & P 500 had one of its strongest monthly returns in several years posting a 7.85% increase with most global markets following suit. In fact, from the August 25th low to the end of October, the S & P 500 has surged approximately 14%.

As of this writing equity investors have changed direction once again. They are now concerned that the Federal Reserve will raise rates due to a very strong labour market. Markets have fallen from their October highs and are showing weakness in November.

The casual observer of financial markets must think that all of these short term gyrations are similar to the speculative atmosphere of a gambling casino. And with good reason! There seems to be no rational cause for the value of businesses to fluctuate wildly on a daily basis. Yet institutional and retail investors constantly make decisions based on all sorts of information that has nothing to do with the underlying long term value.

At Patient Capital we simply don't react to such information. We view it as a distraction and ignore anything that doesn't add to our understanding of a business and its value. As all of you are aware, we take the opportunity to buy from overly pessimistic sellers and sell to very optimistic buyers. We behave in this manner without hesitation and with total confidence.

We are often asked how we are able to make such contrary decisions in the face of often overwhelming popular opinion. The answer is straightforward. Our decisions are guided by our focus on the company's intrinsic value. This emphasis on the long term value of the business allows us to ignore the "noise" and concentrate on what truly matters. The intrinsic value is truly the point of reference for all of our investment decisions. With this well thought out and rational anchor the decision becomes very straight forward. Does the share price sell at a substantial discount to the company's true worth or not? If the answer is yes we purchase; if not we pass.

There are two primary types of information that investors must deal with. The first is macro or non-company specific information. For example, central bank deliberations, economic statistics, market movements, political developments to name a few. At PCM virtually all of this "macro" information is irrelevant because it rarely impacts the long term value of the business. For example, an increase in the number of people employed or the monthly economic growth rate have no relevance to the value of a business. Very rarely, does a "macro event" impact long term value. In the event that it did, we would simply go back to our valuation models, change the assumptions and update our value. For example, if a new government were elected and corporate taxes increased we would change the tax rate in our models and act accordingly.

The second and perhaps bigger challenge for most investors is ignoring the "chatter" on specific companies. This information comes from many different sources; brokerage analysts, the news media, other investors etc. As one would expect, negative information is highlighted when the business is out of favour and positive attributes are stressed when the share price is increasing. Over the past thirty years I have come to observe that such information is usually very short term and/or very subjective in nature.

In our process we input only objective and factual information into our analysis. Any concerns that are raised are evaluated within this framework. The investment decision is made solely on the facts and the value of the underlying business.

An excellent example is Cenovus Energy, currently trading at $20.00. Our detailed analysis indicates that this high quality company is worth approximately $36.00 per share based on our long term oil price assumption of $60 USD per barrel.

Aside from the decline in the price of oil there are three common concerns with respect to Cenovus:

- management issued equity below net asset value;
- the sale process of their royalty properties was delayed;
- administrative costs were far higher than their competitors.

Below we present a very simplified but representative approach to evaluating each of the matters raised.

Management Issued Shares Below Intrinsic Value at $22.25 per share

Net Asset Value Before Equity Issue		Net Asset Value After Equity Issue	
Total Asset Value (YE-14)	36,746	Total Asset Value (YE-14)	38,146
Less Liabilities (YE-14)	8,074	Less Liabilities (YE-14)	8,074
Divided by Shares	757	Divided by Shares	829
NAV per share	**37.87**	**NAV per share**	**36.30**

The analysis above indicates that the equity issue was dilutive by a mere 4%! In our view this very small reduction in value was worth the tradeoff for a stronger balance sheet in a period of commodity price uncertainty. This is no reason to avoid the shares or sell them.

Cenovus Sold the Royalty Lands at a Much Later Date than Management had Indicated

Net Asset Value Before Royalty Sale		Net Asset Value After Royalty Sale	
Total Asset Value	38,146	Total Asset Value	38,646
Less Liabilities	8,074	Less Liabilities	8,074
Divided by Shares	829	Divided by Shares	829
NAV per share	**36.30**	**NAV per share**	**36.88**

We can factually see that delaying the sale of the Royalty Lands was not material. As a matter of fact, management marginally increased net asset value through the sale. Once again, this argument is no reason to sell the shares.

High Administrative Costs

It is absolutely true that Cenovus' administrative costs were above some of its competitors. However, these higher costs are reflected in our cash flows and net asset value. At $20.00 per share the current valuation more than discounts these higher costs. Interestingly, a ten per cent increase or decrease in administrative costs impacts intrinsic value by an astonishingly insignificant twenty cents per share.

Each of the three concerns discussed on their own and in combination sound quite serious. Without any factual guideposts for evaluation, Cenovus Energy does not appear to be an attractive investment opportunity. However, when we quantify each issue and look at the facts in a disciplined and consistent manner, what appears to be substantive turns out to have an immaterial impact on intrinsic value and potential long term returns.

The full process outlined above takes a tremendous amount of work, experience, and expertise. At PCM we take much time and pride in making sure that our analysis is accurate. We back test and check with management to verify that our models closely approximate the company's operations and cash flows. Our valuation methodology is also quite complex and detailed.

All of this painstaking research provides a disciplined framework to decision making. As a result, we can make investments that go against the crowd and maintain our conviction as share prices fluctuate; often dramatically.

We cannot do what we do without your support. Your trust in our process and your focus on the long term allows us to implement our decisions. At PCM there is nothing more exciting than buying a dollar for fifty cents!

Thank you for giving us the opportunity to pursue our passion!

Vito Maida
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