



# Winter 2016

It finally happened!

After never having posted a negative calendar year return since our inception in March of 2000, we recorded a small loss of -2.75% in 2015. While we are disappointed that “the streak” is over, we are also somewhat relieved. The expectation among some was that we would never show a loss leading to unrealistic expectations and more fundamentally, a misunderstanding of our process. Our fifteen year winning streak led some to believe that we were market timers or that we had some “magical” ability to get in and out of volatile markets.

During 2015 we increased the invested portion of our portfolio as some investment opportunities that met our criteria became available; most notably in the Canadian energy sector. While our recent investments have shown “quotational losses”, the real drawback to our performance in 2015 was the simple fact that our largest holding, T-Bills, provided virtually no return. In the past, our large cash balances earned an interest rate of three to four per cent. This interest income along with the dividends from our equity investments was enough to offset any temporary capital losses providing a positive total portfolio return.

The good news is that we continue to add value; particularly over the long term. We have outperformed the benchmark, despite substantial cash balances, across all significant time periods as indicated in the table below:

**Patient Capital Management Compound Annual Rates of Return as of December 31, 2015**

	PCM	TSX
Since Inception	6.51%	4.55%
Five Years	5.47	2.30
Three Years	5.24	4.62
One Year	-2.75	-8.31

<sup>1</sup>Inception Date March 31, 2000  
Before Fees and Expenses  
Based on PCM Total Composite Returns  
Past Returns not Indicative of Future Returns

What stands out from the figures noted above is the very low rate of return earned by the Canadian equity market. A 4.55% compound annual rate of return over 15.75 years is hardly the return that those espousing fully invested equity portfolios expected. As our clients and longtime readers of this newsletter know, we have very often cautioned that the potential long term return available from equities did not justify the risk. Our view has always been guided by standard valuation metrics. With few exceptions, valuations have been substantially above long term averages for much of the past fifteen years. Not surprisingly, long term returns were sure to be well below expectations.

Looking to the future, we believe that long term equity returns in Canada will be higher than in the past as the recent market declines have created undervaluation in the resource, energy and financial sectors. These three sub-indices make up a large part of the S&P/TSX Composite Index and should generate above average long term returns lifting the entire index. On the other hand, U.S. equity markets are still trading above long term valuations and as a result will likely provide lower than expected returns over the next several years from current levels.

The charts below support our conclusion. The Canadian market is closer to its long term average valuation than is the U.S. equity market and thus poised to provide a better long term rate of return.

#### Canadian Equity Value/GDP



#### U.S. Equity Value/GDP



As we write this newsletter, equity markets around the globe have posted losses so far this year. Several factors have caused these jitters: concern over a slowing Chinese economy, lackluster global growth, falling commodity prices and uncertainty over the timing of the U.S. Federal Reserve's future interest rate increases. Global political tensions and a series of devastating terrorist attacks have also added to investor fears and market volatility. While the large market swings of late can be unnerving, we are comfortable that a dangerous systemic risk does not exist. In our view, the current downdraft is a much needed correction towards more normal valuations.

We are excited and welcome the volatility. We hope that investors get ever more fearful so that we can eventually invest all of our cash resources in securities with the potential for long term returns. Times like these set us up to generate substantial long term returns. However, it is important to note that we cannot pick the lowest price a security will trade at and as a result will invariably suffer "paper losses." These temporary share price declines do not concern us in the least. The companies that we invest in are well managed, have sound balance sheets and continue to provide products and services that generate cash and value irrespective of the underlying stock price movements. In three to five years we expect each of our investee companies to have higher revenues, earnings, cash flow and dividends. Consequently, the share price should follow and provide the return we expect.

Historical market returns have been disappointing and prospective returns in virtually all asset classes are unattractive. Year-to-date losses across global equity markets are not helping sentiment. In this environment it is quite natural to seek and leap for the promise of higher returns. Recently we have seen three investment products being promoted that have performed well recently but will likely lead to very poor long term results if not outright permanent losses of capital:

**Equity Products:** funds that have benefited from a significant exposure to the USD are being advertised as excellent performers. Canadian equity funds that had substantial exposure to U.S. dollar assets and U.S. equity funds quoting performance in Canadian dollars did particularly well last year as they benefited from a climb in the U.S. dollar. The S&P 500 in Canadian dollars increased 20.52% while the very same index increased by 1.38% in US dollars. This dramatic currency benefit is not sustainable and likely to reverse in the future.

**Fixed Income:** The returns experienced in fixed income instruments are likely to be negative over the next several years; particularly in traditional government type instruments. Fixed income performance has been driven by dramatically declining interest rates. Interest rates are expected to be much higher five years from now than they are today resulting in widespread losses. On an after-tax inflation adjusted basis bonds are virtually guaranteed to lose money going forward. To make matters worse, some products promise very high yields. These products often quote returns substantially above government and corporate rates. It is quite likely that these products are returning capital; that is they are giving original investors some of their principle back and calling it income! These products are misleading and should be banned.

**Investments in Private Equity and Infrastructure:** Some time ago these two asset classes offered a great opportunity and in some cases still do. However, before jumping in we would advise close scrutiny of all fees and reported performance. Often, quoted returns are before substantial fees and based on “internal valuations” for portfolio holdings. In addition, capital lock-ups and penalties for early exits can make investments in this area quite problematic and expensive should an unexpected need for liquidity arise.

In an environment where earning returns are expected to be challenging, the old adage “If it sounds too good to be true it usually is” are wise words to heed.

It has been extremely satisfying to practice what I believe in an uncompromising and disciplined manner. Your support over the past several years has been extraordinary. These feelings have been tempered by the difficulty that we have had in finding suitable investments. This situation may be changing; if markets continue to behave as they have so far this year we may get fully invested. Nothing would make me happier; even with the very real possibility of experiencing short term quotational losses.

The prospect of playing offense is very exciting!

Vito Maida  
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