Fall 2017

Global equity markets continued their advance unabated in the third quarter. Devastating natural disasters, threats of nuclear war on the Korean Peninsula, a poisoned political environment in the United States, terrorism threats, nor the prospects for higher interest rates in the US and Europe were enough to shake investor conviction over the last several quarters. Markets have continued to climb this “wall of worry” into what is now the second-longest bull market in modern financial history. These rising prices have led to ever higher and riskier valuations. As we recently stated, at these valuation levels the risk for the permanent loss of capital is quite high and the prospects for future returns are very low if not negligible.

This year our portfolios have been impacted by two prevalent views driving investor behaviour. The first is the belief that demand and price for oil and gas will drop precipitously and quickly as electric vehicles, increased production from US shale oil producers and renewable energy replace fossil based fuels. To borrow a phrase, this view is “Fake News”.

Here are the real facts:

> There are two million electric vehicles (EV’S) in use today. That number is expected to grow to one hundred million vehicles by 2035. Despite this fifty fold increase, EVs will only make up ten per cent of all vehicles in use and oil demand is expected to grow from today’s level of 96.6Mb/d to 110Mb/d in 2035;
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> Approximately eighty per cent of global liquids production is already in decline and exacerbated by an unprecedented fall in investment since 2014. At the same time, oil demand continues to grow. A supply crunch is expected in the next three years. The odds of an oil shortage are heightened by very low global excess capacity and increasing geopolitical risks;

Researchers at the Massachusetts Institute of Technology recently published a report that suggested US shale oil production is not sustainable at current levels as decline rates will be higher than previously thought;

Every credible international research organization forecasts "Peak Oil Demand" decades into the future. Some even question the concept of Peak Demand.

Investors are ignoring the facts and, in particular, buying into the belief that electric cars will quickly displace traditional vehicles. This view is most directly manifested in the valuation of Tesla, an electric car producer.

Table 1 below, compiled from Capital IQ data, presents the valuation of the three largest U.S. automakers vs. Tesla. Tesla has only sold eighty thousand cars while Fiat Chrysler and Ford sell five and six million cars annually. Yet Tesla has a higher market valuation than either automaker. General Motors sells ten million cars annually and is only slightly more valuable than Tesla. Put another way, the market is valuing each car produced by Tesla at 100x more than a car produced by the big three automakers! In addition, any measure of value clearly indicates wildly optimistic growth expectations for Tesla.

TABLE 1

Tesla vs. Big Three

	Units Sold	Market Cap.	Value/Car Prod.
Fiat Chrysler:	5MM	26.6B	$5,320
Ford:	6MM	48.5B	$8,083
GM:	10MM	63.8B	$6,380
Tesla	80K	53.4B	$667,500

Company Comp Set

Company Name	TEV/Total Revenues	TEV/EBITDA LTM - Latest	TEV/EBIT LTM - Latest	P/Diluted EPS Before Extra	P/TangBV LTM - Latest	NTM TEV/Forward	NTM TEV/Forward	NTM Forward P/E (Capital
Ford Motor Company	1.1x	11.0x	32.4x	12.3x	1.5x	1.13x	14.12x	7.28x
Fiat Chrysler	0.2x	2.1x	3.7x	7.6x	NM	0.19x	1.62x	4.67x
General Motors	0.7x	5.4x	9.9x	5.5x	1.3x	0.82x	5.53x	6.11x
Tesla, Inc.	7.6x	122.0x	NM	NM	12.7x	5.17x	58.30x	NM

This belief is so strong that investors are ignoring the electric car maker's many production, technological and financial challenges. As well, all of the major global car manufacturers have announced plans to build electric vehicles.

Consequentially this view has created substantial value in the oil and gas sector. Low cost, strongly financed and well managed energy businesses are selling at substantial discounts to their intrinsic values. The potential for earning substantial returns in the oil and gas industry is far greater than an investment in Tesla shares with substantially less risk.

Another prevalent belief that has impacted our portfolios is that consumers will do all of their shopping online and eventually abandon all traditional retailers. More Fake News. Investors are assuming that Amazon will sell everything to everyone! As Table 2 illustrates, the disparity between Amazon's valuation and the valuation of traditional retailers reflects this view.

TABLE 2

	MKT CAP ($ MM)	Net Income ($ MM)	Dividend Yield	Trailing P/E	Trailing P/S	Forward P/E
Macy's, Inc.	7,304	619	6.30	10.50	0.30	7.20
Wal-Mart	291,431	13,643	2.10	25.90	0.60	21.10
Target Corp.	33,528	2,737	4.00	12.90	0.50	14.50
Nordstrom, Inc.	7,623	354	3.20	16.00	0.50	15.40
Bed, Bath & Beyond	3,303	685	2.60	5.90	0.30	7.90
Kohl's Corp.	8,041	556	4.60	12.60	0.40	12.80
The TJX Comp.	47,284	2,298	1.70	20.20	1.40	17.80
Best Buy Co.	17,601	1,228	2.30	14.80	0.40	14.00
Group	416,115	22,120	3.00	14.80	0.50	14.50
Amazon	559,584	2,371		296.10	3.40	190.40

Source: Capital IQ
Total Group Market Cap and Net Income are Totals
Group Valuation Statistics are Averages

The retailers listed in Table 2 have had long and successful histories; collectively they generated a total of $22.12 billion in net income last year. Amazon generated just $2.37 billion or a little more than ten per cent of the group's total income. Yet Amazon is currently worth $143.5 billion more than all of the retailers in the table combined.

In the belief that Amazon will eventually dominate all retail sales, investors are overlooking low returns on invested capital and minimal profitability as Amazon achieves scale, market leadership and revenue growth.

We have analyzed Amazon in some detail and strongly believe that the company's current retail business model is unsustainable in the long term. Although we can't be certain, we have concluded that after taking into account the cost of goods sold and shipping costs, Amazon likely loses cash dollars on its direct retail sales business. Amazon can't make it up on volume. The more that Amazon sells of its products, the more cash it bleeds. Unless Amazon raises prices or starts charging for shipping, continued surging direct sales growth will lead to mounting financial strains.

For Amazon shareholders, it's a "catch twenty-two". If management continues on its present course it will eventually become apparent that cash flow is being constrained. On the other hand if management raises prices and does not subsidize shipping costs then sales growth will likely slow. In both cases the share price declines.

Irrespective of our view of the business fundamentals, at current prices, Amazon shareholders are quite likely to suffer substantial losses. In our experience we cannot recall a situation where the shares of a large company ever earned a positive return when trading at a triple digit earnings multiple.

Retailing has always been a very competitive industry. Many retailers and formats have come and gone. Not all retailers will survive the current

competitive environment. Well capitalized retail businesses, with strong brand names, providing consumers with appropriately priced goods and a positive shopping experience will whether the current storm. Many of these retailers are trading at single digit multiples and offer the potential for substantial long term capital appreciation.

Investors in companies like Amazon and Tesla are feeling very good right now as they count their profits while investors in most traditional retailers and energy companies are understandably disappointed as share values fall. However, for the true long term investor these gains and losses are meaningless.

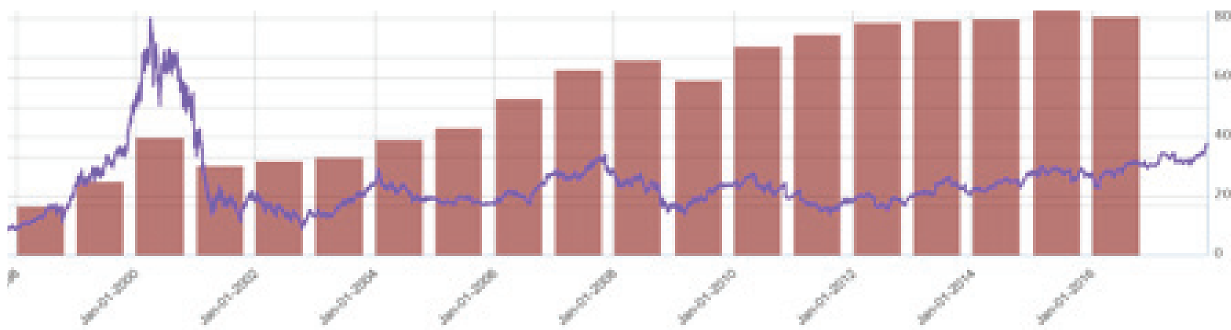
There are two types of investment gains and losses. There are real investment gains and speculative gains. And there are quotational losses and permanent losses. Real investment gains are returns earned through thoughtful investment in securities of sound businesses that are fairly/attractively priced. A sound analytical framework can objectively support the investment thesis. These gains are sustainable and repeatable over a long period of time.

Speculative investment gains occur through the purchase of substantially overvalued securities irrespective of the quality of the underlying business. These gains are based on wildly optimistic assumptions, unrealistic expectations or simply a concept that captures the popular imagination. They cannot be justified by any rational or traditional investment analysis. These gains occur because market enthusiasm pushes prices ever higher. Speculative gains are not sustainable or repeatable. Amazon and Tesla shares fall into this category.

Permanent losses occur through the purchase of securities trading substantially above intrinsic value and/or investment in poor businesses. These losses arise from the type of speculative investments described above. Ultimately, speculative gains result in the permanent loss of capital. These losses can never be recovered and are extremely damaging to long term financial plans and goals.

Chart 1 vividly demonstrates an example of a speculative gain that turned into a permanent loss of capital. As the purple line shows, Cisco's share price reached $80 in 2000. At that price the P/E ratio was 200x. The red bars represent Cisco's revenues. Despite the fact that sales doubled during the past seventeen years investors who purchased the shares in 2000 have lost nearly fifty per cent of their investment! This is a permanent loss of capital.

CHART 1
Cisco Systems
Share Price and Revenues 1998 - 2017



Source: Capital IQ

Quotational losses result from share prices that for a time drop below the securities' initial cost. If the investment was made in a sound business purchased at a discount to its true value then the losses are temporary and should be of no concern. In due course the value will be recognized and a profit will be realized.

At Patient Capital we experience quotational losses quite often. However, as you have seen, with one exception, all of our quotational losses have eventually turned into substantial gains. Confidence in an uncompromising process and patience allow us to make substantial returns despite experiencing temporary paper losses. A supportive client base also helps!

Chart 2 illustrates one of many examples of a quotational loss that turned into a large profit. In 2008 we invested in WellPoint (now Anthem). At the time, WellPoint was one of the leading private health insurers in the United States. There were concerns that the Affordable Care Act would eliminate the need for private American insurance companies. Consequently, the company's share price dropped dramatically. We were able to purchase a premier company at a substantial discount to its book value. We made our original investment at approximately $50. We experienced a quotational loss as the shares dropped below our initial cost but in 2014 sold them at more than a $100 per share.

CHART 2
WellPoint (Anthem) Share Price 2008 - 2014

Source: Capital IQ

Currently we are experiencing quotational losses in some of our energy and retailing companies. More important than the short term share price fluctuation is the underlying performance of the businesses that we own. Each of our investee companies continue to show improving operations, strengthening competitive positions, reduced costs and solid balance sheets. As a result, we are quite confident that each of these investments will generate a profit over the long term as their underlying value surfaces.

All of us at PCM want to thank you for your continued trust and support. We wish you and all of your families a wonderful holiday season and much happiness and good health in the New Year.

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