# 2016 YEAR END COMMENTARY

Almost two years ago, when we decided to return to Goodman & Company, we had a vision of starting a new business with a familiar corporate partner, friends, family and past loyal clients. We are sincerely grateful to all of these parties who helped make this vision a reality.

At this time of year, many investors attempt to forecast what will happen over the next 12 months. Lao Tzu, a 6th century BC poet observed, "Those who have knowledge don't predict. Those who predict don't have knowledge". Despite these age-old words of wisdom, the investment industry seems to insist on producing forecasts. This is all the more puzzling given the track record of those forecasts.

Following one of the worst starts to a year in equity markets, very few were predicting the S&P 500 would rally 27% off its February lows, in fact, one strategist told investors to "sell everything". By the summer of last year, investor attention was focused on whether or not Britain would vote to remain in the European Union. Almost all financial market participants and commentators were predicting the outcome would be to remain united and it was generally agreed upon that should they vote to leave, financial markets would experience a strong selloff. They were wrong on both fronts. A few months later, most experts were not expecting a Trump victory and almost everyone expected financial markets to plummet should he have won. Again, they were wrong on both fronts. An enormous amount of evidence suggests that investors are generally hopeless at forecasting. In our opinion, using forecasts as an integral part of the investment process is like tying one hand behind your back before you start.

Warren Buffett has said that "a true investor should not buy and sell stocks based on what other people think the stock market is going to do, but rather by what they think the company is going to do." An important principle behind our approach to investing is to consider ourselves long-term owners of a business. Rather than trying to forecast short-term macro events, our focus is how they may or may not impact our existing and/or potential holdings — market speculation is not part of our DNA. Good stock selection is far more important to us than guessing where the markets will go. We concentrate on what we can control and this begins with analyzing businesses, in which we hope to invest, from the bottom up. We believe the best way to protect capital is by investing in businesses that possess strong competitive advantages with attractive valuations.

## Positioning

One of the most noteworthy moves we made last year was in our asset allocation. We continued to lower our exposure to bonds as well as reducing the duration risk in our accounts. In our opinion, the 35-year decline in interest rates ended in the summer of 2016. As yields normalize over the coming years, we expect to see interest rates continue to rise coincident with improvements in global GDP and a likely pickup in inflation. Should this occur, total returns for bonds (including government) will likely remain low at best. As we see the risk/reward for fixed income being skewed negatively, we remain cautious in our approach for now.

For the past few years, and more recently in our third quarter commentary, we argued that, in general, stock prices have been expensive relative to our assessment of their business values and we therefore invested defensively (carried higher cash balances). Our caution has cost us some potential return in the near term and while this is annoying, we remain steadfast in our belief that it would be risky to chase performance by making investments we do not believe in. To quote Buffett again, "Why risk what you have and need for what you don't have and don't need?" Our primary goal remains preserving and growing our clients' wealth in real terms.

Thankfully, this objective gives us the freedom to invest without worrying about mimicking any benchmark. Regardless of our opinion on the valuations of stocks and bonds in general, we believe there are a few great investment opportunities out there today.

## Citigroup

One of our larger holdings is Citigroup. Citigroup shares have done well recently, along with the other bank stocks and trade at roughly $60. We believe the shares remain significantly undervalued and the path to continued gains will come from a combination of management actions and an improved external environment (better economic growth, more favourable regulatory environment and higher interest rates). Surplus capital is also being distributed to shareholders in the form of dividends and buybacks.

Lastly, we expect the continued runoff of its non-performing loan book, as well as the benefit from its deferred tax credit, to result in returning further capital to shareholders.

Within two years, we believe the earnings potential of the bank can be more than $7 a share, up from the $4.70 it's expected to have earned in 2016 and the book value could rise to approximately $80. In a recent Barrons interview, Bill Nygren, portfolio manager of the Oakmark fund said "Banks deserve to trade at meaningful premiums to book values. Investors punished the industry because the steps companies were forced to take to improve the quality of their balance sheets hurts return on equity. On the flip side, the excess capital makes banking a safer business. Some investors worry that more regulation will turn banks into a stodgy, slow-growing business that resemble electric utilities. But electric utilities trade at 1.5 times book value." At 1.5x book value, Citigroup is worth more than $100. Another way to look at it is over the past 20 years, banks have generally sold at about a 20% discount to the S&P 500 multiple. The index is trading at approximately 18 times earnings, so a 20% discount is 14 times earnings. If we correctly assume Citigroup will earn $7 a share two years from now, a P/E multiple of 14 makes it a $100 stock. This type of risk/reward is exactly the opportunity we get excited about.

### Coca-Cola

Coca-Cola is one of the oldest and best-known brands in the world. While most investors are concerned about what "sugar taxes" will do to consumption growth, we believe they are missing the significant strides the company has made at diversifying away from its flagship carbonated soft drink products into "still" beverages (including bottled water). They are also missing the incredible growth opportunity the company has in Emerging Markets. According to the consulting firm McKinsey & Company, the Emerging Market soft drink opportunity could be worth $2 trillion by 2020, which is more than four times larger than the global soft drink market today. We also believe investors are not giving the company any credit for the transition it is undergoing to an "asset-light" strategy. Coca-Cola has roughly $24 billion in cash and marketable securities, 90% of which is held abroad. If the new administration enacts a tax repatriation holiday or lower tax rate, Coca-Cola and their shareholders could be one of the bigger beneficiaries. In our opinion, investors are significantly under estimating the normalized earnings power of the company and, as a result, the shares continue to trade at a significant discount to our estimated intrinsic value. We believe our patience will be rewarded and over the course of the past year we selectively added to our position.

Thank you for your continued trust and we wish you all the best in the New Year. If you would like to speak to us about your portfolio or any other matter, please do not hesitate to contact us, we are always available.

Sincerely,

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