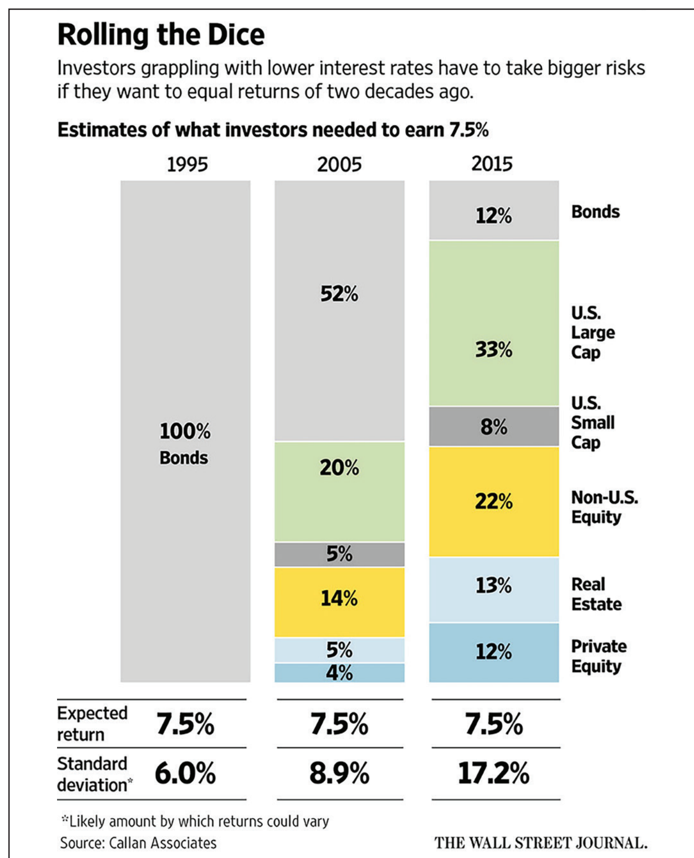
THIRD QUARTER 2016 COMMENTARY

There is little doubt the world we live in today is fraught with risk and uncertainty. Whether it be from the ongoing turmoil in the Middle East, terrorist attacks, the political circus in the US or the negative interest rates on close to $14 trillion worth of bonds, we are definitely living in interesting times. In the financial markets, we continue to witness the largest policy experiment of our lifetime. One of the ramifications of this experiment by central banks has been to push investors further out the risk curve to reach for returns.

Chart 1

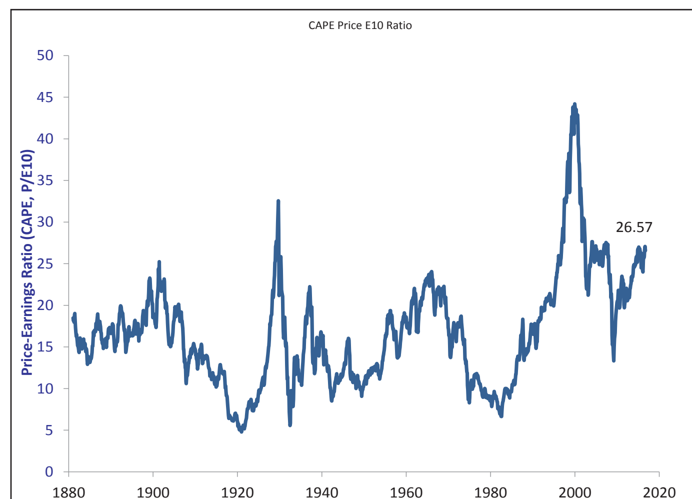


At Goodman & Company, we try to find companies that will be worth significantly more five and ten years from now, and we buy their shares when they are mispriced and offer us a margin of safety. When we cannot find great companies to buy at a price providing us a margin-of-safety, we are happy to hold cash and wait for such opportunities to present themselves.

Eventually, they always do. As equity markets globally reach new highs, those opportunities have become scarcer. The cyclically adjusted price/earnings ratio (CAPE), based on the S&P 500's current price divided by its average earnings over the past 10 years adjusted for inflation, currently stands at 26.6, well above its long-term average of about 16 (Chart 2). Today's valuation falls into the top tenth of historical observations, based on data since the 1880s. While pricey valuations do not necessarily mean the market is poised to drop, high valuations have historically limited future return

When the CAPE is in the top decile, as it is now, the S&P 500 subsequently averages about 4% annually for the next 10 years.

Chart 2



Source: www.econ.yale.edu/~shiller/data/ie_data.xls

When returns are the primary goal, there is a tendency to take excessive risk (buying assets at unattractive prices), and future returns are usually unsatisfactory. The most important metric to us is not the returns achieved but the returns weighed against the risks incurred. Consideration of risk must never take a backseat to return.

Below is an excerpt from an article we recently read:

> *What seems to be unfolding – and I whisper these words because they are among the most dangerous in investment – is a new valuation paradigm. Equity investors are following their counterparts in the bond world in starting to think that maybe it really is different this time…*
>
> *The collapse in bond yields around the world to zero and beyond in many cases represents an epochal upward revaluation of fixed income investments. To understand the scale of this, you need only look at a 50-year Swiss government bond that now offers a negative yield. Investors are prepared to tie their money up for half a century for no return at all.*
>
> *But that mutation of the "lower for longer" interest rate outlook into a "lower forever" one is now being picked up by equity analysts. If interest rates stay on the floor, they are starting to argue, the average cost of capital for the average business in their spreadsheets is way too high. If capital is assumed to be permanently cheaper, the value in today's money of future cash flows must rise. And so, therefore, must share prices.*
>
> *You can probably see why I'm nervous. Investors tend to talk about new valuation paradigms at five minutes to midnight on the stock market clock. Remember all the guff during the dotcom bubble about eyeballs mattering more than earnings? But remember, too, that Alan Greenspan was talking about "irrational exuberance" in 1996, four years before the market peaked.*
>
> **http://www.telegraph.co.uk/business/2016/07/30/something-is-stirring-up-stock-markets-and-its-not-brexit/**

In the current environment of low to negative interest rates, investors are being encouraged to allocate more capital to risk assets to boost portfolio yields. It was legendary investor Sir John Templeton who famously said, "The four most dangerous words in investing are, it's different this time." We will never disregard valuation risk and take on more risk than we deem appropriate to lift expected returns.

There are two main risks forever present in investing: the risk of losing money and the risk of missing an opportunity. In our opinion, too many investors are focused on the latter. We prefer the risk of lost opportunity to that of lost capital.

Valuation ultimately determines what is risky and what is safe. In defining risk as the potential for something to go horribly wrong, we insist every investment should be purchased at a price that provides an acceptable margin of safety. Participating when prices are high rather than shying away is the main source of risk. When looking at potential investments, before we even consider what our upside is, we always ask, "What is our potential downside?"

Our discipline does not allow us to blindly follow the herd in believing this time is different and that we are in a new valuation paradigm. Instead, we remain true to our investment discipline and let business fundamentals and valuations dictate our investments. As such, our cash balances are higher than usual, as we refuse to push the envelope in the short-term and risk sacrificing our clients' long-term objectives. Our primary aim is to protect the real value of our clients' capital over the long term.

We invest client capital as we invest our own, because we are invested right alongside you.

There was no significant activity in our accounts this past quarter. However, rest assured, that does not mean we took the summer off. We are constantly educating ourselves on our craft, as well as expanding our "circle of competence" with respect to potential business investments. Although valuations do not afford us an appropriate margin of safety today, we want to make sure that our homework is done so we are ready if and when such an opportunity presents itself.

Time will tell whether or not we are in a new valuation paradigm. One thing we guarantee we will never change is our goal of preserving and growing the capital you have entrusted to us.

Below we provide highlights from one of the books we have recently read:

ACCOUNTING FOR VALUE
The author, Stephen Penman is an accounting professor at Columbia Business School. The first chapter of the book is Return to Fundamentals. The book lists 10 principles distilled from years of practice by fundamentalists. "Most are just plain common sense."

1. One does not buy a stock, one buys a business
2. When buying a business, know the business
3. Price is what you pay, value is what you get
4. Part of the risk in investing is the risk of paying too much
5. Ignore information at your peril
6. Understand what you know and don't mix what you know with speculation
7. Anchor a valuation on what you know rather than speculation
8. Beware of paying too much for growth
9. When calculating value to challenge price, beware of using price in the calculation
10. Return to fundamentals; prices gravitate to fundamentals

Thank you for your continued trust and support and feel free to reach out to us.

Sincerely,

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September 2016

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