

HAVE A STRONG GAME PLAN

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Like many others, we spent the first weekend in February watching the Super Bowl with family and friends. In what could be a storybook ending to a great career, Peyton Manning and his underdog Denver Broncos pulled off the upset over the Carolina Panthers to win the Lombardi trophy. With the Broncos sporting the league's top defense, many pundits are once again shouting the old adage "defense wins championships"; but we took a few more investing lessons away from Sunday's game.

The Broncos had a simple goal, to win the Super Bowl. In order to do that, they played to their strength; defense. In investing parlance we can say that the Broncos invested within their circle of competence.

Leading up to the game, people asked how the Broncos would react to the opposing team's seemingly unstoppable force, MVP quarterback, Cam Newton. As it turns out, the answer was that they would do the same thing they did to Tom Brady two weeks earlier in the AFC Championship game, they would make Newton react to them.

Denver's defensive coordinator, Wade Phillips' solution was a tactic called a "green-dog blitz", an aggressive yet relatively safe way to address a dual threat (passing and running) quarterback like Newton. The plan worked to perfection. Newton looked nothing like the MVP quarterback he had been proclaimed just the day before the game. He and the regular season's best offense scored a season low in points (10) and gave up season highs in turnovers (four) and sacks (seven).

Charlie Munger, business partner to Warren Buffet, famously said "Invert. Always invert!". To be successful, it is important to start with the end goal in mind and devise a plan from there that suits your individual needs and risk tolerance to meet that goal. This differs from the

conventional view of asset management where financial performance and success is defined by a return against an investment benchmark. If you needed your initial capital to pay for a home renovation or your child's tuition, what good is beating an index by 10% over a five-year period when the index is down 20%? Some people call that a success. We do not.

Our objective at Goodman and Co. is to earn a reasonable real rate of return over the long term, by first and foremost preserving your capital. Managing risk is central to our investment approach and informs every decision we make on your behalf. The importance of protecting capital cannot be overemphasized. The fact that Manning finished the game with a meager 13-of-23 passing for 141 yards, and the Broncos did not score an offensive touchdown until very late in the game was irrelevant. The defense had done a stellar job and ensured that even a modest return from the offense was enough to reach their goals. We apply a similar approach to investing.

Our strategy, at its most basic, is one of ownership. We view ourselves as capital allocators, not traders, and therefore view our role as investors in businesses, not speculators. We construct our portfolios with high quality businesses that have pricing power, attractive growth opportunities and that are unlikely to self-destruct. We believe these businesses are best suited to withstand a number of possible outcomes in today's macro environment. We only invest in these businesses when we believe they are trading below their intrinsic value – when these wonderful businesses are temporarily out of favour with the market. Call that our defense.

Our offense comes from two areas: our conviction to concentrate our portfolio in our very best ideas, and our willingness to hold large amounts of cash. We believe

holding 20 to 30 high-conviction ideas is better than holding 100 low-to-medium conviction ideas. Using another sports analogy; if you could, would you not want your best players on the field at all times? We build our portfolios one stock at a time, picking those that we believe offer us the most favorable outcomes with the least amount of risk while ensuring we have appropriate diversification across sectors. If we cannot find investments that meet our criteria, are uncertain, or lack confidence, we have no problem holding cash.

While the conventional view amongst many asset managers is that cash is a drag on performance, we believe cash is like holding an option to buy virtually any asset – with no expiration date. The offense comes not from necessarily holding the cash in the portfolio, but from aggressively deploying it when the market invariably serves up highly attractive buying opportunities.

DISCIPLINED EXECUTION / AVOIDING DISASTER

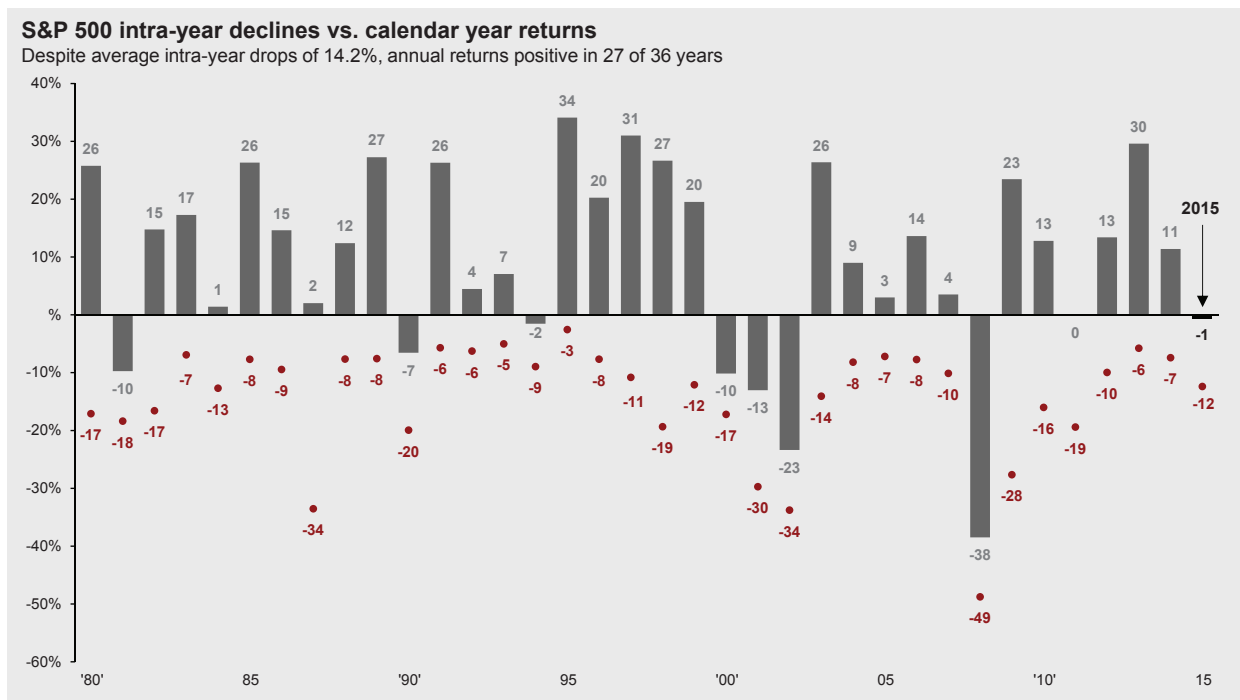
The contrast between the two opposing quarterbacks throughout the game was clearly evident. At one point, the Broncos went 31 minutes of the game without a first down. Did Peyton Manning panic? Nope. He just kept going about his business, playing not to lose and avoiding crippling mistakes. He did not try to be a hero and go for a high risk, high reward play. There was no need. The Broncos defense was executing the team's plan to perfection. Manning knew that if the defense continued its play and the offense avoided costly turnovers, they would win the game.

The story on the Panthers side of the ball was very different. The persistent Broncos defense was causing fits for Newton and the rest of the team. His facial expressions throughout the game conveyed a sense of deep stress. His frustration was clearly getting to him on the field (and was even more evident during the post-game interview!). He let his emotions get the better of him and an excellent player began making out of character mistakes – plenty of them.

Similarly, we believe one of the most dangerous things an investor can do is let their emotions get the better of them and deviate from the plan in the midst of a difficult situation. Pressures, anxieties, tensions and fears seriously degraded Newton's decision making ability. They do the same thing to most investors. Human psychology drives natural loss aversion and herding biases that lead many investors to make poor decisions at the worst possible times. Many sound investments are sold at the bottom of the market simply because of these natural biases and a lack of conviction. As Benjamin Graham said "The investor's chief problem – even his worst enemy – is likely to be himself."

Since 1994, Dalbar, an organization focused on investor behavior and communication, has measured the effect of investor decisions to buy, sell and switch into and out of mutual funds over short and longer-term timeframes. The results show that the average investor earns less – in many cases, much less – than the funds they are invested in. The main reason for the underperformance: individual investors were following their instincts and pulling money out of, and adding to, their funds at precisely the wrong times.

CALENDAR RETURNS AND INTRA-YEAR DECLINE



Source: J.P. Morgan Asset Management, FactSet, Standard & Poor's. Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns shown are calendar year returns from 1980 to 2015. Guide to the Markets – U.S. Data are as of December 31, 2015.

As can be seen in the chart above, the market regularly offers plenty of opportunities to make crucial mistakes. Mike Tyson said, "Everyone has a plan until they get punched in the mouth." When the market declines, like the collapsing pockets around Cam Newton, will you panic or stay the course?

Our investment process has proven its ability to withstand punches in the mouth and is designed to address the kind of biases that negatively impact investment returns. We execute deep due diligence to have a full understanding of any business we invest in. That gives us a basis of confidence in our positions even during periods of significant market disruption. We openly and actively challenge our views of the future and our underlying assumptions. We have dissected our mistakes to ensure

we do not make them again. We avoid acting on emotions. And we only buy shares in businesses that we would be happy to hold for several years.

Similar to the Denver Broncos, we have a sound plan and if we execute on our defense and avoid the big losses, we believe even a modest offense can produce attractive results and successful long-term compounding.

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