Forward thinking. Finding value.

MANAGER'S 1st HALF COMMENTARY – FELIX NARHI

"The markets are moved by animal spirits, and not by reason." – John Maynard Keynes

The year started in the midst of one of the greatest bull markets in history. It has only strengthened in 2017. The S&P500 bull market is now the second longest (trailing only the 1990-2000 cycle during the dot-com era) and the third strongest in history. In his 2016 year-end commentary, Pender President and Portfolio Manager, Dave Barr mused about the improving merger and acquisitions environment. Forecasting is often perilous, but given the backdrop, this was a relatively safe prediction. After all, M&A activity tends to pick up near the end of bull cycles, when confidence amongst executives tends to be highest, corporate coffers are gushing with cash after the good times and executives take their cues from other acquisitive peers. *Times may change, but human nature does not.* Pender certainly benefited from these improving animal spirits. Two of our largest holdings - Panera Bread and Whole Foods – became targets of takeout offers in the second quarter. In contrast to many investors, we only viewed one of the acquisition announcements as great news because of how we categorize our investment universe.

While many investors cheered the Panera Bread takeout news, we viewed the announcement as bittersweet. Why? Although we generated a very attractive return on Panera, we believed the ride ended far too soon. In our view, shareholders were about to enjoy a powerful move higher over the next few years as the payback from an unusually heavy investment period was just being unleashed, similar to other past cycles for Panera (like the patient kids of the famous Marshmallow Experiment – greater rewards come to those who wait!).

"Compounders", or those businesses we define as having the potential to increase their *per share* intrinsic value at mid-teens pace or better over time account for the *vast majority of the stock market's total returns over time*. Unfortunately, finding attractively priced potential compounders that are run by outstanding operators - like Panera Bread - is no small task. We acknowledge that in some cases, we simply don't understand a potential compounder well enough to make a big investment, and the ones that we feel competent enough to evaluate are often too pricey. But, once identified, we believe it is important to make meaningful commitments to these compounding companies and to not interrupt the compounding process unnecessarily. Buy low and let grow.

The power of compounding

Holding a portfolio of stocks for long periods allows the power of compounding to work its magic. As one can observe in an index over time, a portfolio comes to be dominated by winning stocks (i.e. FANG stocks[1]) whilst losing stocks keep declining and eventually, become inconsequential. The positive contribution from winning stocks *disproportionately* outweighs the negative contribution of the losers. A simple exercise illustrates this important point. Let's imagine a hypothetical that consists of only two stocks evenly split in a $100,000 portfolio.

	Day 1 Value	Stock Performance	After 10 Years
Stock A	$50,000	Compounds at +25% per annum	$465,661 - up 831%
Stock B	$50,000	Declines at -25% per annum	$2,817 - down 94%
Total Portfolio	**$100,000**	**Compounds at +16.7% per annum**	**$468,478 - up 368%**

Mathematically, one can see that one great investment held over a very long period makes a huge difference to a portfolio, even if some other investments badly underperform. Now imagine what a real-world portfolio might look like after ten years if an investor sold out of Stock A in year one or two after capturing the initial gains of 25-56% and therefore missed out of the rest of the run up to 831%. As famed investor Peter Lynch wryly noted, "*You won't improve results by pulling out the flowers and watering the weeds*." Unfortunately, we believe this describes the fate of the vast majority of investors.

Self-inflected wounds are dishearteningly common when investing (we have made our fair share!). When investing, there are endless ways to make mistakes. But mistakes are more *visible* when an investor misjudges the quality of a business, the ability and intentions of management or overpays for a business. As a result, they

pay the *visible* price when there is a permanent impairment to the business and the stock price declines in response. Stock B could be an example of such a mistake (mistakes of commission). On the other hand, as the compounding example above illustrates, the more serious mistakes are *invisible,* and therefore often ignored by investors (mistakes of omission). Investors occasionally discover and buy terrific, fast-growing enterprises, but voluntarily stop the compounding process themselves by selling such stocks far too early. Indeed, we think virtually every experienced investor can tell stories about stocks that they bought and flipped for a quick profit and which are many-fold higher today. At other times, independent third-parties interrupt the compounding process with takeout offers (as in the case of Panera.) Like the example of an investor who sold out of Stock A early, they missed most of the returns that would have driven the overall portfolio higher over time. "Fast money" wins feel gratifying at first, but are often short-sighted when the stock sold is a compounder. After cashing in their chips, it is rare that the proceeds of quick flips find new reinvestment opportunities that produce returns anywhere near as good as the ones left behind on the compounder's table (omission of those returns are *invisible*).

A big part of the problem when investing is widespread impatience. Portfolio turnover is unbelievably high - speculation is clearly rampant. As Warren Buffett once quipped, "*We believe that according the name 'investors' to institutions that trade actively is like calling someone who repeatedly engages in one-night stands a 'romantic.'"* Growing wealth sustainably takes *time*. Where are the real investors? We believe patience is one of the scarcest attributes amongst investors and hence, one of the most valuable attributes. We believe investors should be greedy when winning with compounders.

Don't be blind to other opportunities in the meantime – "close-the-discount" ideas can pay the bills too

Many investors believe that the markets are efficient (we are looking at you, index investors). They are implicitly betting on the Efficient Market Hypothesis (EMH), or the belief that it is impossible to beat the market because stock market efficiency causes existing share prices to always incorporate and reflect all relevant information. In theory, EMH appears elegant, but in practice it falls short of reality. There's a joke on this subject: An economist walks by a twenty-dollar bill on the sidewalk but decides not to pick it up, because if it were really there someone would have picked it up already.

Compounders are not the only game in town. If you find a $20 bill on the proverbial market sidewalk, you should act quickly and shove it in your wallet! Who cares if it doesn't grow to $30? Opportunistically *buying low and selling high* stocks, through an ongoing series of "Close the Discount" opportunities, can add up over time and is a perfectly sensible investment strategy.

This discussion leads us to the other large takeout - Whole Foods. While we did not want Panera Bread's compounding process to end, we were pleased with Amazon's acquisition of Whole Foods because it was a "close the discount" idea. Our investment thesis recognized that Whole Foods had an exceptional franchise, but that its best growth days were behind it. Whole Foods was formerly a "compounder", but its lucrative honey pot of high returns inevitably attracted more competitors, which reduced its growth potential. In addition, management was slow to react to the increasingly competitive grocery landscape. But when it was trading in the low $30s, we viewed the stock as an attractive idea which could generate a decent return, even though the growth outlook was muted. There were some issues that caused investors to sour on the stock. Ultimately, we believed either the management team would fix these issues (largely traffic-related), or someone else would. In either case, the return profile could be attractive if this discount was closed quickly enough. As fate would have it, Amazon made the offer that effectively "closed the discount" to the intrinsic value gap.

Many paths to investment nirvana

We seek to compound our unitholder's capital at a satisfactory rate over a reasonable period of time. We are agnostic in *how* we compound wealth over time. The compounder route is terrific, but as mentioned earlier, finding compelling opportunities is episodic. That is ok because even a small handful of such outperformers, held over longer periods can make a huge difference to wealth accumulation. But we are also enthusiastic buyers of average companies or slow growers when they are trading at heavily discounted prices, as long as we believe the value gap can be closed in a timely fashion. The only *caveat* to this *agnostic* view is that we are mindful of

the objective to grow long-term wealth on an *after-tax* basis. After all, one can only spend what's left after the government takes its share. As such, investors should always be aware that they will need a higher return with "close the discount" ideas to compensate for the higher turnover to match the return of "compounders." The tax system is set up to reward the patient investors and punish the impatient ones. This is another *secret* advantage for compounders. (For more on this topic, please click here).

Where to look for ideas in an extended bull market

Stacking the odds in our favour with founder-run firms and small-sized companies

Pender portfolios tend to have a founder/ owner-operator bias, primarily because that attribute is one of the biggest anomalies for positive growth in the stock market. We believe investors *systemically undervalue* founder-run companies as a group and, as a result, they tend to outperform the rest over the long haul. When fishing for founder-run companies with long runways ahead, more opportunities exist outside the broadly held S&P500 index. Trading at today's elevated levels, the S&P500 is generally NOT a target rich environment to fish for sensible investment ideas, in our opinion. In addition, the large cap index is compromised mainly of mature companies where the original founders have left the scene long ago. Younger and often smaller companies listed outside the major indices are far more likely to still have founders at the helm.

Episodic opportunities are available in just about every market – bull or bear

We believe intelligent investing is an exercise of attempting to obtain more (business) value than one is paying for (in the stock price.) *After all, who wants to pay more than the value they obtain back?* Where can one look for potentially undervalued ideas? To us there are only two kinds of stocks: Companies that are *HAVING* problems and companies that are *GOING* to have problems. The former are *cheap today* while the latter will be cheaper at some later date. Company-specific "accidents" or "hiccups" are likely to occur to just about every firm at some point. These tend to be episodic and not necessarily related to general market conditions. This means that an everchanging stream of potential ideas will often be available, irrespective of whether the broad index is in bull or bear market territory. Why not concentrate the search for ideas in the *cheap today* pile?

Thoughtful investing has always been a probabilistic exercise. Investors always have a choice of where to look for opportunities and these will shift over time. At certain times, it makes more sense to be aggressive, while at other times, one should be more defensive. We have written in the past commentaries that just about everything is cyclical to some extent. Nobody knows exactly where the bottom or top of a market is, but simply appreciating where the cycle is - early, middle or late - can provide some very helpful guidance on how to position a portfolio and where one should look for ideas in order to stack the odds in one's favour. The S&P500 of 2009 had far more target rich opportunities than the S&P500 of 2017. Investors that ignore this cycle do so at their own peril.

Felix Narhi, CFA
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For full standard performance information, please visit: http://www.penderfund.com/funds-and-performance

[1] FANG Stocks – Generally accepted acronym for Facebook, Amazon, Netflix and Google (now Alphabet)

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