



Forward thinking. Finding value.

MANAGER'S Q4 COMMENTARY – FELIX NARHI

“Since 1871, the market has spent 40% of all years either rising or falling more than 20%. Roaring booms and crushing busts are perfectly normal.” - Morgan Housel

Last year was a banner year in the US markets. Following the election of Trump, the S&P500 bolted out of the gates on initial optimism for deregulation across many sectors and ended the year with investors cheering huge US corporate tax cuts. In what has become a familiar refrain, a handful of mega cap internet and technology stocks continued their momentum.

The party on Wall Street didn't end on New Year's Eve. The gala continued right into 2018 as January's total return marked the best start to a year since 1997. Indeed, since Trump was elected President, the US markets have largely shrugged off the political sideshow and chaos of the White House as the S&P500 put together an uninterrupted 15-month rally with no losing months on a total return basis. That period was the longest streak in the history of S&P500, beating the previous record of 10 months, set back in 1995, by a comfortable margin.

The recent mini-streak ended in early February 2018. The CBOE Volatility Index (VIX), or “the fear index”, which is considered by many to be the world's premier barometer of investor sentiment and market volatility skyrocketed by 116% on February 5th. That was the largest one-day increase ever. On the same day the S&P 500 fell by 4.1%. Investors were provided with a quick lesson on the dangers of short-term speculation and trend extrapolation as leveraged bets on low volatility imploded.

During the S&P500's hot streak, the price index jumped 33% over 15 months. The index outperformed the underlying corporate fundamentals which pushed the S&P500 index even deeper into overvalued territory. By the end of the month, investors had something new to worry about – heightened risk that the Federal Reserve might hike interest rates faster than expected following growing signs of inflation.

Don't get your teeth kicked in

“The most dangerous people in the world are very smart traders who have never gotten their teeth kicked in.” - F. Helmut Weymar

At Pender, we sometimes say that there are only two kinds of companies: Companies that are *having* problems and those that are *going to have* problems. The same is also true for the broader indices – it's just a question of when a major correction will occur as extended periods of tranquility are often followed by not-so-tranquil times. The S&P500 is currently in the midst of the second greatest bull market in length *and* magnitude in history. It is less than a year away from becoming the longest bull run ever. It has been so long since there has been a major correction that the institutionalized memory of the gut-wrenching selloffs that occur periodically in the markets is in danger of fading.

Increasingly, the investors and fund managers who are making important investment decisions have never had their proverbial *teeth kicked in*. A survey of more than 4,800 fund managers in London, New York and Paris conducted last year showed that half of respondents had nine years of experience or less. That means there are thousands of fund managers who didn't experience the 2008 collapse and its run up, let alone the dot com bubble that burst in the early 2000's, the 1997-1998 Asian financial crisis, or the more distant 1987 and 1973-74 market crashes. Unfortunately, what we learn from history is that we don't learn from history. In any case, we keep in mind Buffett's simple guideline, *“The less the prudence with which others conduct their affairs, the greater the prudence with which we must conduct our own.”*

Secret Rule #2 and Patiently Onward

"In a rising market, enough of your bad ideas will pay off so that you'll never learn that you should have fewer ideas." - Daniel Kahneman

Warren Buffett's # 1 rule of investing is "never lose money", followed quickly by his second rule — "never forget #1". While we remain admirers of the Oracle of Omaha, there is a clear flaw with Rule #2. Taken literally, one could put money in a GIC or a t-bill and meet both rules. But after taking into consideration inflation and taxes, investors would be going backwards, never mind have any realistic chance of growing their wealth over time. Rather, we believe Rule #2 should reflect what Buffett *actually did* to accumulate his capital. The real secret Rule #2 is to be patient and to appreciate that investing is an endeavour where magnitude is more important than frequency. In other words, how big your wins are matters more than how often you win. Like many aspects of life, it turns out that capitalism is also beholden to the "80/20 rule". A minority of individual stocks account for most of the stock market's total returns over time, because only a handful of companies create real long-term wealth. The key, in our opinion, is to be patient with such compounders so one can benefit from magnitude in capitalism. This also explains in large part why portfolio turnover and returns tend to be inversely correlated. It's hard to keep up when you sell the Starbucks, Amazons and Berkshire Hathaways of the world early-to-midway through in their respective lifecycles.

We believe it is important to see the world as it really is in order to stack the odds in one's favour. It turns out that successful long-term investment strategies are also beholden to the "80/20" rule. The greatest flaw in short-term investing is the belief that great business performance is always linear. Time tends to push out the weakly convicted and creates opportunities for those with a long-term perspective. An idiosyncratic and patient approach to portfolio management is not practiced by many, but it tends to work over the long haul because it is aligned with how the world really works. Don't just take our word for it. Recent [research](#)* concludes that among high Active Share portfolios - whose holdings differ substantially from their benchmark - *only* those with *patient investment strategies* on average outperform. This successful group represents a very small percentage of all active investors. In large part, incentives driven by short-term relative performance and benchmarking prevents most managers from implementing the secret Rule #2 in their investment strategies. Yet these real-world findings have clear implications for today's active vs passive debate.

Read more on how long-term considerations impact our investment strategies as they relate to interest rates, disruptive business models and cycles (including comments on individual holdings) in this [Investment Insight](#).

Please do not hesitate to contact me, should you have questions or comments you wish to share with us.

Felix Narhi, CFA

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* Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently, *Journal of Financial Economics*, Martijn Cremers, Ankur Pareek, December 1, 2015.



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