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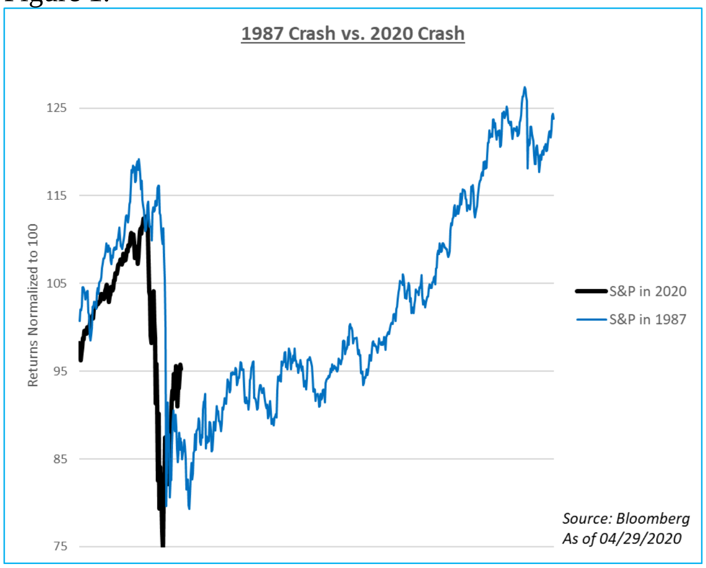
INVESTMENT ISSUES • STRATEGIES • INSIGHTS FROM DONVILLE KENT

Rebound

In our update to clients on both March 18th and March 30th, we charted this year's decline versus the 1987 stock market. At the time, we were unsure when the market would bottom. We have updated that chart below and will explain the reasons why we believe the rebound has already begun.

Figure 1.



As of March 31st, the Capital Ideas Fund was down 26.23%[1] versus the TSX Total Return Index down 20.90%[2], the S&P 500 Total Return Index down 19.59%[3], and the Russell 2000 Total Return Index down 30.61%[4]. As you can see with the decline of the small cap benchmark (Russell 2000), our exposure to small caps drove the decline but since the end of March, we have now bounced back substantially. This decline may have been the reset that sets the stage for the next cyclical leg to move higher.

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Figure 2. **Comparative Returns Since Inception October 2008**

	Total Return	Annualized Return
DKCI[1]	341%	13.8%
S&P 500 Total Return Index[3]	183%	9.5%
Russell 2000 Total Return Index[4]	99%	6.1%
S&P/TSX Total Return Index[2]	61%	4.2%

Over the Horizon

The most common and fair question we are getting right now is how can we be positive about investing in stocks considering the uncertainty currently in the world. No one is feeling the pain more than small businesses and those that have been laid off. However, the stock market is not a reflection of the economy we see out the window or on the news. The stock market is a prediction of what the economy is going to be in the future.

The idea that the economy is not the stock market is very important. The real economy lags the financial economy. The stock market is forward looking and investors get paid for taking risk. By waiting for certainty, or as one approaches certainty, the rewards diminish. Today, if one were to wait for a vaccine against COVID-19 or wait for the economy to return to "normal," much of the return will have already been rewarded to those who were willing to invest earlier on. The stock market is an expectation of the economy 6-12 months from now.

In studying past downturns, it becomes very apparent that maximum pessimism in the stock market bottoms well in advance of maximum pain in the economy. Entering 2009, the economic outlook was dismal — GDP growth was negative, jobless claims were hitting multi-decade highs, and the stock market was down more than 45% from its peak. Again, the destruction and disarray were front and center, and an investor would have had a myriad of reasons for not wanting to risk putting money into that environment. The point is, at the beginning of 2009 if an investor had waited for an economic "green light," like waiting for the economy (GDP) to stop declining, they would have had to wait another *13 months* before seeing that trend start in January 2010. Over this time, the TSX Index was up more than 31% (S&P 500 +29%).

The quote below is from our January 2009 newsletter.

"A rebound in markets and asset prices generally will typically be driven by two factors and these are 1) improving levels of market confidence and 2) a rebound in forward earnings. Our expectation is that a rebound in confidence will come first and the rebound on the earnings front will only be apparent well after the market has begun to rebound."

In the same newsletter from 11 years ago, we quoted Randall Gilberd of Rockridge Partners in Palm Springs, California. Gilberd wrote in his January 9th, 2009 letter to investors, *"We don't require economic nirvana to record substantial gains from here."*

History has shown that big gains follow dramatic declines (figure 3). Our fund's historical best return was in 2009. We are seeing similar opportunities in the small cap technology space right now.

Figure 3.

Past S&P 500 Bear Markets	
Date of Market Bottom	Market Return Next 12 Months
March 2009	69%
October 2002	34%
December 1987	23%
August 1982	58%
October 1974	38%
May 1970	44%
June 1962	33%
June 1949	42%
June 1932	121%

Source: Bloomberg

Marathon Not a Sprint

We do not believe that buying and selling stocks based on a short term outlook or according to the latest headlines translates into a long term winning strategy. Short term trading not only relies too much on emotion, it also does not appropriately weigh the short term versus the long term when it comes to value creation. Time and time again we see investors place too much emphasis on the current year or even the current quarter results. Instrumental valuation tools, by contrast, appropriately balance the short term versus the long term.

By using a theoretical example with the associated financial math, we think our point will be made clearer and you will understand how we can be positive on stocks in this environment even though values have declined in the short term.

We believe the current value of a business is based on the future economic value that the business will create. A Discounted Cash Flow analysis (DCF), is a financial tool used to present value the future cash flows of a business. Picture an independent car dealership that has been operating a single location for a decade. Say this shop has been making $1,000,000 per year in cash flow. They have a great location and loyal customers and under normal circumstances you would expect this trend to continue. Due to COVID-19, their revenue drops to zero and their cash flow declines to negative $250k in 2020. This business runs responsibly, carries zero debt, and plans to fully re-open in 2021. Using a discounted cash flow analysis under this scenario, how much value has the COVID-19 pandemic taken from this car dealership? Doing the math, you find that a full one-year shutdown lowers their value by just over 6%[5].

Obviously, what is happening in the real world right now is not as clean and crisp as this. Real results will range over a vast spectrum. On one end of the spectrum you will have bankruptcies, and on the other, the strong companies will grow and gain market share. The point is that the stock market can be emotional and what we saw in March was that people would rather *sell now and ask questions later*. If the car dealership were a public company, their stock probably would have sold off more than 30% in March, just like many small cap stocks.

This is why we think there are good opportunities in this bifurcated market. There are stocks that are currently down 50-70% from their highs, where the underlying value of the business is only down slightly. If you are confident a business will survive, then a one-year downturn is not as punitive to a company's value as one would assume. The divergence of the weak from the strong has not been this apparent in a long time, if ever.

Recovery May be Quicker Than You Would Think

The 2009 stock market recession is still front and center in the minds of many investors. In recent years, any mention of a forthcoming recession would elicit feelings from one of the worst economic periods in almost 100 years. In addition to the disconnect we are seeing in individual company valuations, as explained above, there are three other factors that distinguish this recession from past longer lasting recessions like 2009.

Pace of the Decline - In 2008/2009, it took the market 363 days to go down 35%. This year it took 33 days — the fastest in history. The pace of the decline is important because it got more people's attention and motivated them to act more quickly. The speed of the drop this time panicked investors faster, dropped consumer confidence faster, and made governments respond even faster.

Timing of Government Intervention - In 2008/2009, the Fed waited *6 months* after the crash of 2009 to pull out the "bazooka" and provide liquidity that would fill in the holes of the economy. This time around, the Fed began to stimulate *two weeks* after the decline began and pulled out the "bazooka" on March 23, with an additional $2.3 trillion in stimulus announced on April 9. They have pledged unlimited quantitative easing in order to backstop nearly every aspect of the credit market.

Scale of the Stimulus - The scale of government intervention is on track to be *five times* larger than any past program in history.

The benefits of stimulus are temporary, and the long term unintended consequences are unknown. The short term impact however can be extremely effective. The 2008/2009 recession was so painful because as economic activity began to decline, business owners went to the banks with open hands asking for help. However, banks were at the epicenter of that recession and were worried about keeping the lights on themselves. The banks threw up their own as they themselves had bigger issues to deal with. If a business or household had any type of credit issue, they were bankrupt. Pair this with the government waiting 6 months before stepping in, and a lot of irrevocable damage had already been done.

Today, governments have reacted almost immediately, providing "unlimited" liquidity. The banks have been waiving covenants, deferring payments, and providing emergency loans. The goal of financial stimulus is not to solve the problem but rather to keep the economic shock from turning into a full blown financial crisis that interrupts the flow of credit to businesses and households.

On October 20, 1987, *the day after* Black Monday, Fed Chairman Alan Greenspan said "The Federal Reserve […] affirmed today its readiness to serve as a source of liquidity to support the economic and financial system." Sounds familiar. In addition, the Fed encouraged banks to continue to lend on their usual terms. This quick response helped lead to a quick rebound.

We feel like many are succumbing to recency bias and extrapolating the 2008/2009 recession against the current environment. A financial crisis like in 2008/2009 is very different compared to the health crisis today. The great financial crisis produced long-lasting damage to the financial system. At the time, people were scared to have their money in the bank, or in any asset for that matter, for the perceived risk of a complete meltdown. The COVID-19 crisis is a health pandemic with a full recovery dependent on some combination of effective drugs, a vaccine, and herd immunity. Now, like in 1987, the banks are being encouraged to keep companies afloat. The financial economy will survive and many of the surviving companies we invest in will flourish.

Panning for Gold

So how are we positioning the portfolio?

1. Shift to small caps — high quality small caps will beat large caps during the rebound
2. Invest in Technology — this has been validated in the downturn and we expect this sector's relative strength to continue
3. Stay invested —one can't successfully trade in and out of the market
4. Avoid the truly long shots — hotels, oil producers, cruise ships etc.

We think quality stocks, or "compounders" — those with strong balance sheets, growth, and high margins — can go markedly higher from here. Companies that cannot survive a temporary slow down because they carry too much debt, are too low margin (high operating costs), or will lose too much revenue, may not survive.

The divergence between the strong and weak is most evident when you compare technology stocks to the rest of the market. Technology, and software specifically, allows businesses to increase efficiencies and scale their operations. Now more than ever, businesses will need to enable employees to work remotely, move their business to the cloud, and focus on their online sales capabilities. A majority of the fund is invested in tech stocks and we think we are in the middle of technological shift that will see software companies take on an even greater share of the economy over the next decade. **There is no recession in innovation.**

What we are doing is taking apart each company piece by piece to see which ones are the best investments from this point on. We are focused on strong balance sheets, low fixed costs, the ability to remain profitable throughout this recession, and the potential to gain market share due to weak competitors.

Enghouse is run by one of the best management teams in Canada, has over $110m of cash, and offers a secure teleconference business that is used by hospitals (telehealth) and financial institutions, as well as other communication software services.

Adcore has been around for over 15 years, 14% of their market cap is in cash with no debt, and it offers software that enables small and medium sized businesses to track the performance of their ad spending online.

VitalHub offers software to medical facilities in order to increase safety and efficiencies like tracking hospital bed usage, and now has over 70% recurring revenue. They have a proven management team and are sitting on 30% of their market cap in cash.

Tucows is a utility company for the 21st century, enabling people and businesses to access the fastest internet, create websites, and have access to mobile plans at a fair price.

Sangoma has a new management team that has transformed the business from a hardware business to a software as a service business. Their products are essential in a tech-enabled workforce and they recently launched their newest cloud service — Video Meetings.

Final Thoughts

It is the stocks you buy in the worst of times that lead to great returns in the best of times.

Being able to capitalize on market dislocations after a crash has led us to some of our best investment opportunities. As a result of the crash in 2008/2009, Carfinco Financial dropped to $0.24, Paladin Labs dropped to $9.00, and Constellation Software went down to $22.50. If you were basing your investment decision on 2009 earnings, none of these stocks would look like screaming buys. Carfinco got acquired for $11.25 five years later, over the next four years Paladin's stock climbed above $142.00, and Constellation now trades at $1,356.12[6].

This is the type of dislocation we are seeing with some high quality stocks right now, especially in the small cap technology space. This is why we see great opportunity in the current market landscape.

We would like to thank you, our clients, for continuing to believe in the process. We hope this newsletter, aimed at answering the most common questions we have received, was helpful. We absolutely understand your concerns and worries about the markets this past quarter, but we want to reassure you that this too shall pass, and we believe we are well positioned to capitalize on the upside. As always, please feel free to reach out with any comments or questions.

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All estimates, projections, and calculations have been generated by DKAM. This does not constitute advice for personal investments but rather a breakdown of how Donville Kent approaches stock analysis.

1 Time weighted rates of return for Class A Series 1, net of all fees and expenses as of March 31st, 2020.
2 S&P TSX Composite Total Return Index is the Net Total Return version of the S&P/TSX Composite Index.
3 S&P 500 Total Return Index is the Net Total Return version of the S&P 500 Index.
4 Russell 2000 Total Return Index is the Net Total Return version of the Russell 2000.
5 DKAM calculation using 5.12% WACC and terminal value calculated after year 5.
6 Price as of 04/29/2020.