We are here

30Jun15

To my Partners:

I apologize for the delay in writing this. Before I get into a discussion of the Trust, I ought to first chat for a second about the recent market volatility. As discussed in the past, the US market for some time has been relatively expensive and investor sentiment quite positive. In other words, the “Stairway to Heaven” was not leaning against the strongest of branches. (I use a branch analogy as I use to pick apples as a summer job; I quickly learnt not all branches are created equal)

The blame for recent stock market weakness has fallen on China. I am not so sure the explanation is that simple nevertheless the market has concluded unlike Vegas where what happens in Vegas stays in Vegas, what happens in China casts a dark shadow over everyone. China has long been (as Bill Gross has said) the “mystery meat” of international finance meaning few have a clear understanding of what is happening and why. I share this cautiousness as a lack of transparency rarely leads to positive surprises (similarly I have seldom found the mystery meat in my sandwich was filet mignon). To me, this reinforces one is better off focusing on prices than predictions. Volatility of course comes with this but patience and margin of safety are key.

As Benjamin Graham (“father of value investing”) has said, a stock at one price may be attractive while at another it is expensive. What matters is the price you are paying versus the intrinsic value of the company. What gives us the opportunity as value investors is market behavior periodically causes situations where price and intrinsic value differ. In other words, our focus is the intersection of emotion and arithmetic.

Value investing and margin of safety seem simple concepts but this approach differs significantly from many investors’ approach which is to focus on the prospects and quality of a company with little regard for pricing. A positive future can be manufactured easily in any spreadsheet. In fact, I would suggest equipping an optimistic analyst with an excel spreadsheet is like giving a 16 year-old boy Viagra. Yikes on the outcome!

Value investing is the complete opposite of the ETF phenomena. While I agree fees are an important consideration, investing with no regard to fundamentals regardless of the cost is hardly the answer. As discussed in our Annual Report, with an ETF as money flows into the structure, it is automatically invested in the underlying securities. As you can imagine, a popular ETF attracts more money thereby leading to further outperformance and hence additional monies. In other words, it is the ultimate momentum machine resulting in price movements being magnified. George Soros many years ago coined the phrase “reflexivity” to describe this type of situation. Nevertheless, this virtuous circle continues with no regard to the intrinsic value of the underlying securities. (Of course, this circle works just as effectively in reverse but I suspect the term “virtuous’ may not be used in that context). I believe a significant amount of the price volatility of the last little while has been caused by ETF flows. For example, large redemptions of ETFs lead to indiscriminant panic-like selling. This can hardly be thought of as thoughtful investment.

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Circling back to fees for a second, the Trust has always had a performance fee. At this time, we still have a shortfall in the Series B units which many of you own. Performance is the only cure which aligns our objectives completely.

I wanted to take this one step further and have created a new unit series (Series C) which only has a performance fee and no management fee. I modelled it after the fee structure Warren Buffett used with his Buffett partnership in the 50s. I don't really recommend you switch your Series B units as you have the benefit of a performance fee shortfall but if you are considering adding to your position, this may be an attractive opportunity. To clarify, the underlying fund remains the Trust, this is simply a different fee structure. We would be happy to send you a copy of the Offering Memorandum if you have an interest. Please call or email us.

Portfolio Update

In the first six months of the year, we realized net gains of some $1.8 million. The bulk of this was due to the sale of half of our position in VOYA Financial. Other significant contributors included the sale of a portion of our holdings in Carmanah and our entire stake in Navient.

We recently added to our position in Glacier Media. Glacier has been a longtime and disappointing investment. I joined the Glacier board in April 2014. The primary issues Glacier is dealing with are the decline of its community paper business, the cyclicality of its oil and gas and farming business, the breadth of its operations and its balance sheet. For me, the latter is the most important. A positive development has been over the last year or so, Glacier has sold over $40 million of assets not essential to its core operations. In addition, the board recently suspended Glacier's dividend. This has led to volatility in its shares. Volatility in share price is something that I expect in an investment. The key is to stabilize the underlying intrinsic value. Sam Grippo (Chairman) and Jon Kennedy (President) are both very focused on operations, cashflow and asset rationalization. Furthermore, both (as well as other insiders) have recently bought shares in the market. In sum, it has been a long wait but good things are happening.

One of the stars of 2015 has been our holding in Carmanah Technologies. Carmanah's stock performed very strongly in 2015 driven by operational improvements and strategic acquisitions. We trimmed our position slightly in late spring effectively taking our cash cost "off the table". Nevertheless Carmanah remains an important position. John Simmons, CEO, is fabulous and improvements in LED, battery and solar technology are effectively improving Carmanah competitive position hence providing a tailwind.

One of our dogs has been Legumex Walker. Legumex announced in late April that it was putting itself up for sale. In one of the more bizarre twists I have seen, lenders to one of Legumex's subsidiaries in late July effectively called for repayment of their loans leading to a wild scramble by management to both find a deal while trying to keep the wheels on the bus. Legumex continues to suggest a transaction of some sort is about to be concluded. I am hopeful this will be a save but not yet counting my chickens.

On the topic of potential deals, we continue to have a large holding in BHF Kleinwort Benson (BHF). You may recall in 2014, RHJ International (a long standing position of ours) acquired BHF Bank in order to expand its presence (via Kleinwort Benson) in private banking. To reflect its new focus, RHJ changed its name to BHF Kleinwort Benson. In early August, BHF received an unsolicited takeover bid from one of its shareholders. A couple of weeks later, another group indicated it may also make an offer. The bottom line is we are in limbo at the moment as we wait to see what transpires. The stock continues to trade below book value and I am cautiously optimistic on the outcome.

Outlook

Our puts and cash, combined with the possibility of offers for our holdings in BHF Kleinwort Benson and Legumex Walker mean the liquidity of the Trust is pretty good. Market gyrations aside, business is going reasonably well for most of our holdings and their balance sheets are improving.

I know our structure is fund-like but the Trust is hardly an ordinary mutual fund. My focus is very much on the path less traveled especially as this gives us a competitive advantage in pricing when we invest. As John Templeton has said, if you do the same things as everyone else, you will get the same results. I do realize volatility is unsettling. Certainly the financial newscasters make each event feel like either the opportunity of a life-time or the beginning of the apocalypse. As I close this note, I want to stress you are not invested in an ETF. I am involved with a number of our holdings and our money is invested alongside yours. The bottom line is my job is to guide us through periods like this and I am grateful for your patience and confidence.

Performance:

The McElvaine Investment Trust's 30Jun2015 net asset value for the Series B units was $22.4867. This represents a gain for the first six months of 2015, net of all fees and expenses, of 5.3%. During this period, the S&P/TSX Composite Total Return Index rose by 0.9%.

Conclusion:

As always, many thanks for all your support and confidence. I appreciate your trust.

All the best,

Tim McElvaine
31Aug2015