Logos: The Third Quarter

As of October 1st, 2016

"Time is your friend; impulse is your enemy." – Jack Bogle

The current price per unit is $22.30 and although this is well above our initial offering of $12.52, we have experienced some volatility in the portfolio since our last quarterly letter due to declines in certain peripheral positions. We believe these declines will continue in the short to medium term as these peripherals are going through important periods of business transition. During these periods it is crucial to remember the wisdom of Howard Marks:

"Superior investors know -and buy- when the price of something is lower than it should be. And the price of an investment can be lower than it should be only when most people don't see its merit."

As we wait for the tide to turn, we caution that above-average returns in the short-medium term will likely remain elusive. Furthermore, we alert investors that given what appears to be a "bull market in everything" climate, risk is high and prospective return is low. Whether it's the threat of nuclear war, hurricanes, or Russian meddling, it seems nothing can unnerve investors intent on pushing the U.S. stock market higher and higher.

Persistently low prospective returns on safe investments (the ten year) are motivating investors to take more risk – which they are willing to do – at a time when the reward for doing so is low. Given this climate, we have opted for a rigorous and consistent application of Ben Graham's concept of a "margin of safety".

The following table represents Logos LP's total unlevered net return as of the second quarter compared to a basket of relevant indexes:

	YTD	**Since Inception**	**CAGR**
Logos LP in $CAD	15.57%	80.37%*	18.06%*
S&P 500 in $CAD	6.16%	64.59%	15.12%
S&P 500 in $USD	14.24%	46.02%	14.86%
S&P/TSX Composite in $CAD	4.45%	22.34%	9.71%

*Since inception (March 26, 2014)

Over the course of this bull market, momentum has largely favored large caps over small caps yet this equation appears to be shifting. As investors focused squarely on the small cap space, this shift doesn't come as a surprise as the market is beginning to price in (accept) favorable domestic economic tailwinds. As for our activity in this space, we continue to see a small selection of attractive names yet we have remained on the side lines as pricing has not met or margin of safety thresholds.

As we re-set expectations in an environment promising lower returns, we have not been active this past quarter.

Currently, we have under 25 names, and we plan on sitting tight, waiting for attractive opportunities that may come along over the next few years. The previous quarter reminds us of a great quote in a great book called "*Reminisces of a Stock Operator":*

> *"And right here let me say one thing: After spending many years in Wall Street and after making and losing millions of dollars I want to tell you this: It never was my thinking that made the big money for me. It always was my sitting. Got that? My sitting tight! It is no trick at all to be right on the market. You always find lots of early bulls in bull markets and early bears in bear markets. I've known many men who were right at exactly the right time, and began buying or selling stocks when prices were at the very level which should show the greatest profit. And their experience invariably matched mine -- that is, they made no real money out of it. Men who can both be right and sit tight are uncommon. I found it one of the hardest things to learn. But it is only after a stock operator has firmly grasped this that he can make big money. It is literally true that millions come easier to a trader after he knows how to trade than hundreds did in the days of his ignorance.*
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> *The reason is that a man may see straight and clearly and yet become impatient or doubtful when the market takes its time about doing as he figured it must do. That is why so many men in Wall Street, who are not at all in the sucker class, not even in the third grade, nevertheless lose money. The market does not beat them. They beat themselves, because though they have brains they cannot sit tight. Old Turkey was dead right in doing and saying what he did. He had not only the courage of his convictions but the intelligent patience to sit tight."*

Jesse Livermore spoke no truer words of how to become a great investor. Although boring, it is temperament that is especially crucial in today's maturing bull market. This is also reiterated by one of our favorite academic speeches by Christopher H. Browne in 2000 who presented to the Columbia Business School a speech titled "*Value Investing and Behavioral Finance*". In it, he describes a woman who was a client of his financial advisory firm Tweedy Browne, during a period of time which was deemed to be a market top as she was facing near retirement:

> "A few years back, a long time client sought out my advice on how she should structure her investments. Her account at Tweedy, Browne was approximately $4 million, and she was fortunate to also own $34 million of Berkshire Hathaway stock at its then price. The client had heretofore lived off her salary of approximately $200,000 but was now retiring. She had made an estate plan which included bequests to her children and certain other charitable bequests. Because a significant portion of her estate was going to charity, a financial advisor had recommended a series of charitable remainder trusts which she could establish with her low cost basis Berkshire Hathaway stock. Once in trust, the stock could be sold without having to pay a capital gains tax, and the proceeds could be invested in bonds to provide retirement income.
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> When I asked her if she thought her Berkshire Hathaway had been a good investment, she said, "It certainly has been." It was in fact the reason she was quite rich. When I asked why she would want to sell it, her accountant responded by saying all her assets were in the stock market and therefore, riskier than bonds. I said the stock market could decline 50% and she would not have any problem finding enough money to support her relatively modest life style. She then said, "So I should do nothing?" I said, "That's my advice." As of the close of the market last night, this woman now has in excess of $200 million and the ability to do more good than she ever dreamed of."

Despite rising Dow components, FAANG stocks and a relatively strong earnings season, we will not be chasing returns as we believe the potential downside to be to high. Furthermore, we are also starting to see many high growth stocks reporting more and more on financial metrics we don't consider when calculating intrinsic value (i.e. non-GAAP earnings and greater emphasis on 'EBITDA').

On the other hand, we continue to favor businesses that are cash rich, strong returns on invested capital and free cash flow while having little to no debt under this wave of rising interest rates. We also like paying for these kinds of businesses at forward-PE ratios below that of the market and below their current growth rates. Stocks may continue to rise over the next while as long as the Fed chooses to keep rates low (anything above 3% makes stocks look rather expensive at current levels), but the margin of safety we look for in small to mid-caps has been increasingly difficult to find, shifting our focus to more “special situation” or “turn-around” opportunities. We have of late spotted such opportunities in the retail and consumer-packaged foods space.

Activities in the Quarter

We only have one net new position, Savaria Corporation, as the name breached our price target level within the quarter.

In response to further weakness, we also doubled down on a couple of peripheral positions already in the portfolio such as Luxoft Holdings Inc. (NASDAQ: LXFT) and AAON Inc. (NASDAQ: AAON).

We were fortunate to pick up both these names during periods of major declines as both were trading below their 50, 100 and 200 day 5-year moving averages. We also exited one larger peripheral position as we believed the fundamentals had changed. On a net basis, we have again increased our cash position for the quarter.

Follow Up on Gentex Inc.

Last quarter, we wrote our bull thesis on Gentex Inc., a leading supplier for niche automotive parts, signaling devices, dimming windows and other electronic devices for the automotive sector. However, on July 13th, Spruce Point Capital released a strong sell rating and short thesis on Gentex Inc., with a price target in the $4.00 - $12.00 range, which is well below our price target of $25/share. Spruce Point cited many “red flags” in the company’s financial statements where the company made contradictory statements across public financial statements and various communications. Whenever we see a short call on one of our names, we take the opportunity to revisit the stock and question our assumptions. To add insult to injury, several investment banks downgraded the stock, sending it to under $16.90 per share, which was below our entry point.

After revisiting the name and re-considering our investment thesis (paying a low multiple for a near double digit growth business with very strong margins) we found no reason to alter our course. Fundamentals had not changed and accusations of misrepresentation seemed misguided. We’ve maintained our long position and since July, the stock has risen nearly 17% with increasing upward volume. We believe the company will continue to move past $20.

The Way Forward

This cycle is no different than any other. Fear of the next crash invariably turns to greed, and the fear of missing out overshadows anxiety about the next crash.

After a period of anxiety induced by the pain many felt during the financial crisis, investors are now accepting the (8 ½ year) recovery and are increasingly willing to pay more for less. We remain unwilling to do so.

So what are we willing to do?

It is far from certain what will trigger the next downturn or when investors should head for the exits. Market timing is and will remain an impossibility as well as a hazard. Let us remember that anyone who owned stocks just before they crashed in the worst bear market since the Great Depression would still have doubled their money as long as they had the temperament — and enough of a financial cushion—not to go to cash.

As such, we will continue to do the things we have always done remaining largely fully invested while accepting that returns will be lower than they traditionally have been. In addition, moving forward into Q4 we will employ more caution than usual especially with regards to price and we will work diligently to find special opportunities that lie “off the beaten track”.

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