

July 15, 2016

This quarter marks the twenty-fifth quarter since the inception of Seymour Investment Management. In the investment industry we often talk in terms of ‘quarters’. Each quarter the companies that we invest in release their financial results, and we spend hours poring over earnings releases and listening to conference calls. Once reporting season ends, our calendars quickly fill with meetings with analysts and management teams of the companies that we invest in that are marketing between ‘quiet periods’. At the end of the quarter, we sit down to write our quarterly commentaries for clients.

Our short-term outlook rarely influences our investment decisions

This quarter, as we sat around discussing topics for our letter, we found ourselves questioning whether the focus should once again be our updated economic and market outlook or perhaps items more relevant to how we actually invest. *While it might seem intuitive that our short-term macro outlook should drive our investment decisions, in reality it rarely does.* In this letter, we attempt to explain why that is and provide insights into our investment philosophy, strategy and process.

The focus of this letter is the differentiated elements of our investment philosophy, strategy and process

When we founded Seymour in 2010, we structured the firm to be a small, employee-owned investment boutique with a low fee structure. We structured the firm to prioritize client interests and avoid conflicts or constraints that might otherwise inhibit our ability to produce excellent investment returns. We have discussed the structural elements that distinguish Seymour at length in past commentaries. *In this letter, we instead focus on the differentiated elements of our investment philosophy, strategy and process.* We discuss in detail the reasons why we limit commodity exposure in our portfolios.

There are many ways to make or lose money in the markets and each strategy carries a different level of associated risk and expected return. An investment strategy that is appropriate for one investor may not be appropriate for another because each individual investor has unique circumstances that impact their investment objectives and time horizon. The importance of ‘fit’ between a client and investment manager cannot be overstated. Our investment approach at Seymour can be summarized as follows:

Our investment philosophy – *We believe that over the long term, superior risk-adjusted returns may be achieved with lower volatility by investing in a concentrated yet diversified portfolio of high-quality equities using a buy-and-hold, low-turnover strategy with only moderate commodity exposure.*

Our investment style – Our investment style is often described as Growth at a Reasonable Price (GARP), which means we seek to identify companies with strong growth profiles that trade at reasonable valuations. Our style is sometimes referred to as Quality Growth. *We focus on high-quality companies with strong management teams that have attractive business models and are well-positioned to grow their earnings and cash flows on a sustained basis over the long term.*

Our investment strategy:

(1) *We employ a buy-and-hold strategy, with low turnover* (the % of the portfolio that is sold every year to buy new positions). We don't try to time the market because it is very difficult to do so. Rapid swings in sentiment, which are very difficult to predict, can have a significant impact on investment returns in the short term whereas over longer time periods, stock returns tend to be much more correlated with earnings growth.

We invest with a long-term time horizon

(2) *We look for well-managed companies with attractive business models and prefer companies with sustainable competitive advantages in growing industries.* We want these companies to be well-capitalized and use debt conservatively. We favour experienced management teams with proven track records. *We try to only invest in businesses that we understand and that have some degree of predictability.*

We try to invest in things we understand and that are predictable

(3) *We manage concentrated yet diversified portfolios.* We typically own 20 – 30 individual stocks in our equity portfolios, with the goal of having large enough weightings in individual securities to reap the benefits from security selection, while having a sufficient number of holdings in the portfolio to achieve the risk-reducing benefits of diversification. While diversification can help mitigate risk, over-diversification can lead to inferior investment returns by diversifying away the gains achieved from individual security selection.

We manage concentrated yet diversified portfolios

Our investment process – *We employ a fundamental, bottom-up approach to individual security selection,* which means we look for great companies to buy regardless of their industry sector. (This can be contrasted with a 'top down' strategy, in which a manager starts with a macro outlook and uses it to determine the appropriate weightings to hold in different industry sectors). We tend to put more emphasis on qualitative factors than quantitative factors. Our due diligence includes a detailed analysis of a company's management, business model and competitive positioning. We read a great deal of research and conduct hundreds of meetings with management teams and equity analysts each year.

We employ a fundamental, bottom-up approach to stock selection

At Seymour, we manage investments primarily for high net worth investors. Most of our clients have sufficient wealth to meet their living expenses and as such, their investment portfolios have very long time horizons, which in many cases extend beyond their own lives given expectations of passing wealth along to family members or charitable organizations. *Many clients tell us that they wish to preserve and grow their capital without taking excessive risks.*

As portfolio managers, we view our role as two-fold: to achieve attractive investment returns while managing risk. One of the key ways we manage risk is to avoid concentration risk by diversifying portfolios across holdings, industry sectors and geographies. While historically portfolios were well diversified across asset classes, an unprecedented decline in bond yields has unfortunately made this a more difficult task. As bond yields have declined, fixed income valuations have risen to record levels, which has greatly reduced the appeal and increased the risk of this asset class.

We diversify portfolios and limit commodity exposure to mitigate risk

Limiting commodity exposure is another way that we mitigate risk. We have long advocated that an active, bottom-up approach to stock selection can help minimize commodity exposure and diversify risk. The steep decline in crude oil prices that began in 2014 has served as a good reminder of 1) how dependent

the Canadian economy is on energy and other resource exports and 2) how heavily weighted the benchmark S&P/TSX Composite Index (and many other Canadian indices) are to resource equities. In contrast, the U.S. benchmark S&P 500 Index has a much lower weighting in resources, providing better diversification for U.S. investors employing a passive, index-driven strategy.

	S&P/TSX Composite Index	S&P 500 Index
	Weight	Weight
Energy	20.1%	7.4%
Materials	13.8%	2.9%
Industrials	8.4%	10.3%
Consumer Discretionary	6.0%	12.2%
Consumer Staples	4.1%	11.0%
Health Care	0.8%	14.7%
Financials	35.8%	15.4%
Information Technology	2.7%	19.8%
Telecom Services	5.5%	2.9%
Utilities	7.5%	3.6%

Source: TD Securities, Seymour Investment Management Ltd.

The challenge with resource investing is that commodity prices are inherently unpredictable

The challenge with resource investing is that commodity prices are inherently unpredictable. Small supply deficits or surpluses, which are difficult to predict, can lead to very significant moves in commodity prices. Moreover, many commodities are impacted not only by supply and demand, but also by speculation and fund flows. Geopolitics can also play a very significant role when it comes to resources, particularly in the case of oil. In the case of gold, which is also viewed as a store of wealth and a hedge against inflation, the number of drivers impacting pricing becomes mind-boggling. This brings us back to our earlier point that “we try to only invest in things that we understand and that have some degree of predictability”. Perhaps not surprisingly, our portfolios do not include any gold investments.

Our views on resource investing are not entirely unique. The following quotes were made by legendary investor Warren Buffet, who is widely viewed as one of the most successful investors in history:

"Gold gets dug out of the ground in Africa, or someplace. Then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head."

"The problem with commodities is that you are betting on what someone else would pay for them in six months. The commodity itself isn't going to do anything for you....it is an entirely different game to buy a lump of something and hope that somebody else pays you more for that lump two years from now than it is to buy something that you expect to produce income for you over time."

The difficulties associated with accurately forecasting commodity prices pose challenges for management teams of resource companies, who need to make long-term capital investment decisions without knowing what price they will ultimately be able to garner for their resources. Moreover, in times of strong commodity prices, competition for limited labour resources drives up costs, which eats into returns. The

Many resource companies have poor historical track records of generating sufficient returns on capital

boom/ bust nature of commodity markets tends to repeat itself, and *not surprisingly, many resource companies have very poor historical track records of generating sufficient returns on capital.*

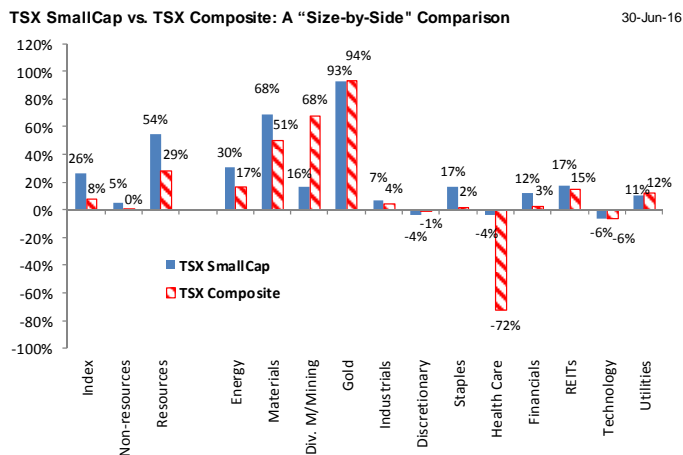
In theory, the laws of supply and demand should result in commodity prices finding support at their marginal cost of new production. High-cost production should, in theory, be shut down when it is uneconomic to produce, eventually leading to supply shortages that drive prices higher, which incents new production. In reality, however, there are many reasons why commodity producers continue to produce when it is uneconomic to do so. During the recent oil price shock, oil production remained much more resilient than expected due, in part, to commodity hedges that producers had put in place prior to the oil price correction. We have also heard instances of companies drilling to retain mineral title rights or producing when they are cash flow negative but EBITDA positive in order to meet debt covenants that are based on EBITDA. We have heard many companies say that they are unwilling to shut down for fear of losing experienced labour that might not return, particularly in remote locations.

The cost curve for commodities is continually shifting

To add to the complexity of commodity forecasting, the cost curve for commodities is continually shifting. Technological changes can make uneconomic resources economic (as we have seen over the last decade in the case of both crude oil and natural gas), and low-cost producers can become high-cost producers when local governments make unexpected changes to royalty regimes or implement other regulatory changes that add to costs.

The preceding discussion isn't to say that we won't invest in resource companies at all. Rather, *the preceding discussion is intended to illustrate the inherent unpredictable nature of resource investing*, and highlight why we believe resource investing is better left to investors that specialize in commodity investing and that follow a trading-oriented strategy rather than a buy-and-hold approach to investing.

The attraction of resource equities is, of course, that they can produce very attractive returns in short periods of time when commodity prices rally sharply. We don't have to look back far in history for evidence of this. In the first half of 2016, the S&P/TSX Composite Total Return Index rose 9.8% (price return of 7.5% plus reinvested dividends), driven by a 29% appreciation in resource equities including Gold equities +94%, Base Metals +69%, and Energy stocks +19%. Non-resource equities have produced mixed returns but on average are flat since the beginning of the year, as illustrated in the chart below. Small-cap resource equities recorded even larger gains.



Source: Scotiabank GBM Portfolio Strategy, Toronto Stock Exchange

When commodity prices rally strongly, we expect to underperform the S&P/TSX Composite Index and other heavily resource-weighted benchmark indices

When commodity prices rally strongly, we would typically expect to underperform the more heavily resource-weighted benchmark indices (such as the S&P/TSX Composite Index or the S&P/TSX SmallCap Index), as we have in the first half of 2016. Although we expect at times to underperform the benchmark indices over shorter intervals, it is our objective to generate superior risk-adjusted returns over the long term (i.e. 5- or 10+ years).

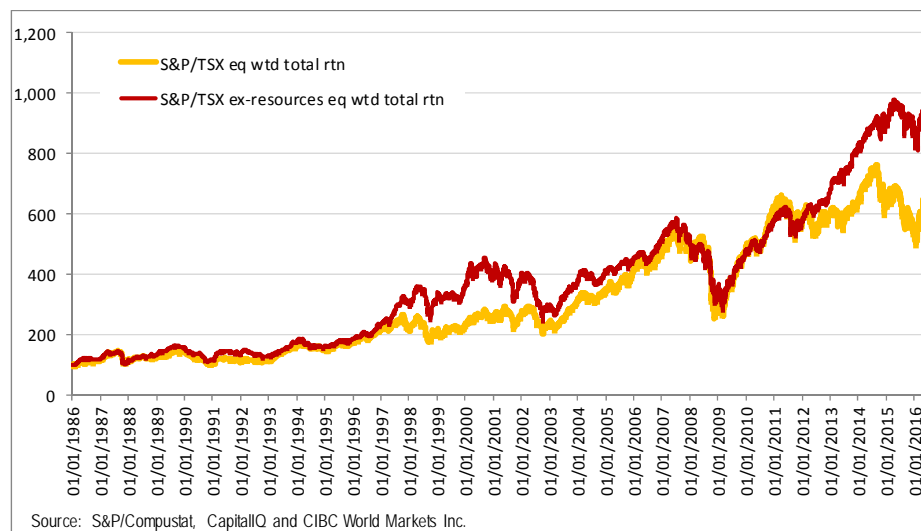
While our primary objective of limiting commodity exposure is to mitigate risk, historical stock market returns would suggest that a non-resource strategy can actually achieve higher returns over long time periods. The chart below illustrates investment returns for the S&P GSCI®, which is a composite index of commodity sector returns that is broadly diversified across the spectrum of commodities. As the chart below illustrates, over the last 10 years the GSCI not only underperformed the broader Canadian equity market, but its returns failed to keep pace with inflation. In fact, the GSCI produced negative returns during this time period.

History would suggest that an investment strategy that minimizes commodity exposure can produce higher returns with lower risk over long time periods

	3M	1YR	2YR	5YR	10YR	25YR
			CAGR	CAGR	CAGR	CAGR
S&P/TSX Composite Total Return Index	5.1%	-0.2%	-0.7%	4.2%	4.9%	8.3%
Commodities (GSCI)	14.6%	-11.6%	-16.8%	-5.4%	-1.0%	N/A
Cash (90-day Tbill)	0.1%	0.5%	0.6%	0.8%	1.4%	3.2%
Inflation (CPI)	1.3%	1.5%	1.2%	1.3%	1.6%	1.8%

Source: TD Securities, Seymour Investment Management Ltd.

The following exhibit charts the S&P/TSX Equal Weighted Total Return Index against the same index **excluding** resource equities. The chart below illustrates over the last thirty years, the non-resource strategy would have significantly outperformed.



One source of risk that we haven't spent much time discussing but that warrants some commentary is valuation risk. Valuation risk is the risk that an asset is overvalued and will be worth less than expected when it matures or is sold. For some time, we have been cautioning that interest rates, which have been on a multi-decade, secular decline, are now at ultralow levels that are unsustainable. When economic and financial market conditions improve, we expect central banks will eventually begin to ease stimulus and

We caution that we don't think the risks in the bond market are well understood

hike interest rates. There is an inverse relationship between interest rates and bond prices. When interest rates rise, bond prices fall and bondholders that sell bonds before maturity incur capital losses. We have cautioned that we don't think the risks in the bond market at the current time are well understood.

In the aftermath of the 'Brexit vote', a flight to safe haven bonds drove bond yields to new record lows. (Brexit is an abbreviation of "British exit", which refers to the June 23, 2016 referendum by British voters to exit the European Union). Roughly one-third of global developed country sovereign debt is now trading at negative yields. (We discussed negative bond yields at length in our Q1 2016 letter).

While early days, our view is that we are unlikely to see any significant or long-lasting impact on our equity holdings from 'Brexit'. The uncertainty associated with Brexit has pushed out the expected timing of the next Fed rate hike and is likely to cause central banks to delay plans to remove stimulus. We'll continue to watch how 'Brexit' unfolds, and in particular our concerns will focus on risks of recession, reduced global trade, and the potential for contagion which could cause other EU members to also look for an exit from the European Union, raising questions about the longer-term sustainability of the euro. For now, we will chalk 'Brexit' up to a significant world event that we expect will have an insignificant impact on how we invest. For those readers that have read this quarter's lengthy client letter to the bitter end, we hope that you will have an understanding of just why that is based on the preceding discussion of our investment philosophy and strategy.

As always, we would be pleased to answer any questions that you may have. We thank you for your continued support and wish you a fantastic summer.

Warm regards,

The Seymour Team