DM Monthly Report

DECEMBER 2017

PORTFOLIO ACTIVITY

During November, we trimmed several positions in DM Foreign Equity and used this capital to add to our position in Comcast, which trades at a below-market valuation. In DM Canadian Equity, we opened a new position in packaging company, CCL Industries.

FEATURE STOCK

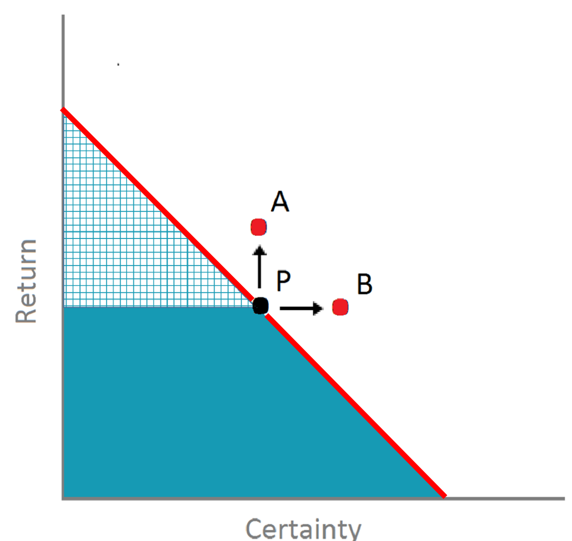
Mastercard Inc. (MA)

At the end of October, MA released quarterly earnings that exceeded expectations by 9% and at the same time announced both a 14% dividend increase and a new $4bn share buyback program to replace the one that will soon be completed. MA possesses one of the best business models in the DM Foreign Equity Portfolio, with a formidable competitive advantage driven by network economics, robust secular growth flowing from the ongoing digitization of payments, and a high margin / capital light operating structure. Recent growth has been helped by management initiatives to boost high margin cross-border transactions and could be further elevated by the company's acquisition of Vocalink, which will give it an entrée into the underpenetrated B2B payments market. With 70% of earnings taxed in the US, MA should also see significant benefit from proposed US tax reform. So far in 2017, the stock has generated a total return of 46%.

INCLUDING RISK IN THE DEFINITION OF PERFORMANCE

When reviewing portfolio performance, investors often want to know how they've done vs. other available options, which might include comparisons against widely accepted benchmarks, other money managers, or even different asset classes. What is often left out of such cursory analysis, however, is risk and how much of it was borne to achieve realized returns. Unfortunately, risk can be a difficult attribute to quantify ahead of time and is often only fully appreciated after the fact, when damage has already been done.

The graphic below illustrates the theoretical risk/return relationship that most investors understand, in which the cost of greater investment certainty (or less risk) is a lower rate of return, and vice versa. If we imagine that the red line is an 'efficient frontier' of risk/return tradeoffs, a portfolio outperforms if its result sits somewhere in the white area to the right of the blue triangle, either by generating more return, taking less risk, or some combination thereof. If, for example, portfolio "P" is our benchmark, a manager will have added value if similar risk has been assumed, but a higher return has been earned (portfolio "A"), or if gains have matched those of the benchmark, despite a material reduction in risk (portfolio "B"). The outcomes in the hatched area are especially worth noting because, even though returns have exceeded those of the benchmark, they have been insufficient to compensate for the elevated risk which was shouldered in their pursuit. Unfortunately, the lure of recent performance can cloud one's assessment of potential peril, leading to investment decisions that are inappropriate at the outset and costly in the future. The unbridled enthusiasm for internet stocks without earnings in the late 1990s fit this definition and some suggest that the present cryptocurrency craze is reminiscent of that time.



Even though anterior risk can be difficult to quantify, it's something we think about all the time in our stewardship of client assets. Aside from avoiding assets whose prices greatly exceed our estimates of fundamental value, we often adjust portfolios to keep aggregate valuations in check and mitigate downside exposure. In recent weeks, for example, we've trimmed weights in several strong performing positions to either reallocate this capital to less expensive names, or to build cash balances that may be redeployed as future opportunities emerge.

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