ANTARES INVESTMENT MANAGEMENT

QUARTERLY REPORT

*For investors who care as much about the return **of** their principal as the return **on** their principal*

Margin of Safety: Quality and Price Matter

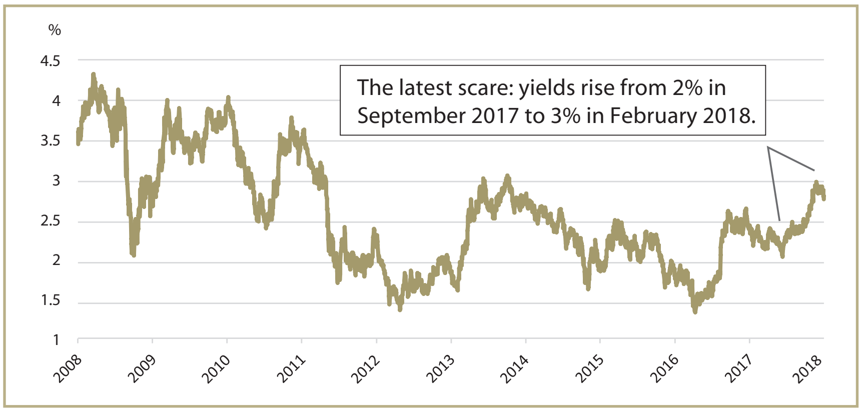
Serious investors are paying more attention to the risk of inflation than to the U.S. President.

As we started 2018, investors were feeling emboldened after several years of equity values expanding. Corporate sales and profits have been on the rise. Employment, particularly in the U.S., is reaching full capacity, and seemingly everybody owns a new car. So, while we are skeptical about high equity valuations, there is a counterargument that they are justified by the facts on the ground. During the quarter, however, cracks emerged. While the media tend to focus on the ongoing drama around the U.S. President – which makes for great copy – we believe that serious investors are paying more attention to the threat of inflation and its potential impact on bond and equity markets.

Figure 1 shows that the benchmark U.S. 10-Year Treasury Bond yield remains low by historical standards, but unsurprisingly has started to rise in the last half year. This is important because the global economy has been underpinned by the resultant low cost of borrowing. This has created the conditions for a bull market in assets such as real estate, infrastructure and equities. If the 30-year bond party is over – and we are not making this call, we are merely highlighting the risk – the hangover could prove ugly. (We recommend shorter parties.) There could be an impact on equities as dividend yields get marked higher by a downward adjustment in share prices, as occurred during the first quarter. The positive counterargument is that higher bond yields are merely a reflection of a stronger economy. A bit of inflation is not necessarily a bad thing. If companies can pass on price increases, profits will continue to grow and so will dividends. In this scenario, companies that can grow their dividends are a more attractive investment than bonds which do not raise their payments.

Modest inflation could be positive if bond yields do not rise too far.

Figure 1 - U.S. 10-Year Treasury Bond Yield: 2008 - 2018



Source: Bloomberg.

Higher-than-expected inflation puts pressure on bond and equity markets.

We believe that a company with a rising dividend stream and a reasonable valuation is likely to prove profitable for the long-term investor. Since the future is unknowable, our task is to manage the risks. To be clear, risk for us is the possibility of a permanent loss in the value of an investment; it is not about the temporary fluctuations in stock prices, which are unavoidable. Therefore, we look for a margin of safety when we make an investment on your behalf. One investor we follow states that "a margin of safety is achieved when securities are purchased at prices sufficiently below underlying value to allow for human error, bad luck, or extreme volatility in a complex, unpredictable, and rapidly changing world." (Seth Klarman, *Margin of Safety*, ch. 6, HarperCollins) His definition falls in the tradition of value investing where one looks to buy shares at a level

Continued on next page

ANTARES INVESTMENT MANAGEMENT
814-1661 Portage Ave | Winnipeg, MB R3J 3T7 | (204) 975-5131 | Toll Free: (866) 975-3888
Fax: (204) 925-5960 | info@antaresinvestment.ca | www.antaresinvestment.ca

ANTARES INVESTMENT MANAGEMENT

QUARTERLY REPORT

Continued

that is cheaper than the value of the underlying business. This makes sense. But at Antares we have an expanded application of margin of safety: in addition to price, we also pay attention to the quality of the business. Quality companies generate sustainable cash flow and manage their debt prudently.

The future is unknowable, so risk management is a key investment goal.

Consider three companies: Tesla and Ford Motor, which you do not own, and Cisco Systems, which you do. Many of us are intrigued by Tesla's promise of less pollution, high performance, and luxury. Over five years, the shares have risen 600%. And yet, as illustrated in Figure 2, Tesla has never made a profit. Ford, on the other hand, has a history of profits, which means it is better positioned for the next downturn in auto sales. Tesla requires billions in capital investment to grow and, as such, is not master of its destiny. The share price has recently declined 35% from its peak as investors appear to be figuring out that the *business* does not have much to recommend to it, even though the *story* is very appealing. From a business perspective, Ford clearly has the superior margin of safety.

The classic notion of margin of safety placed the greatest importance on value. Our notion incorporates a company's quality: its profitability and its debt management.

Figure 2 – Three Companies: Tesla, Ford & Cisco

	Tesla	Ford	Cisco
Price Tag	$52	$45	$205
Sales Last Year	$12	$156	$48
Free Cash Flow Last Year	-$4	$11	$13
Total Free Cash Flow Last 10 Years	-$9	$56	$108
Cash	$3	$26	$74
Debt	$12	$154	$40

Source: Capital IQ. All figures in $ billions.

Conservatively-financed dividend paying equities remain an attractive investment opportunity, irrespective of what happens with inflation.

Let's take the example a step further and examine the debt position of the three companies. Tesla is particularly vulnerable because its absence of profit makes servicing its debt highly challenging, a situation made worse by higher bond yields. Ford's debt is manageable at the moment, but it exceeds both the company's cash level as well as the market value of its equity. Auto sales in North America have been at the higher end of the historic range since 2014, and sooner or later the cycle will deteriorate, making the debt more difficult to service. Evidently, Ford's margin of safety may not be sufficient, at least when compared to Cisco, which has more cash than debt on the balance sheet, i.e. it could choose to repay the debt and still have $34 billion in the bank. Cisco, a leading IT equipment manufacturer, meets all of our tests for margin of safety: valuation remains modest, sales and profits are rising, and the balance sheet is a thing of beauty.

Investing is, at the best of times, an uncertain exercise, and we believe that a heightened level of prudence is called for today. How to achieve it? Our answer: focus on the margin of safety and look for it in multiple ways – business strength, balance sheet strength, valuation. This approach gives us confidence that, whatever happens in the broad markets in the coming months, the companies you hold in your portfolio are solid businesses that, over time, should become more valuable.

Thank you for your continued trust,

Your Portfolio Management Team