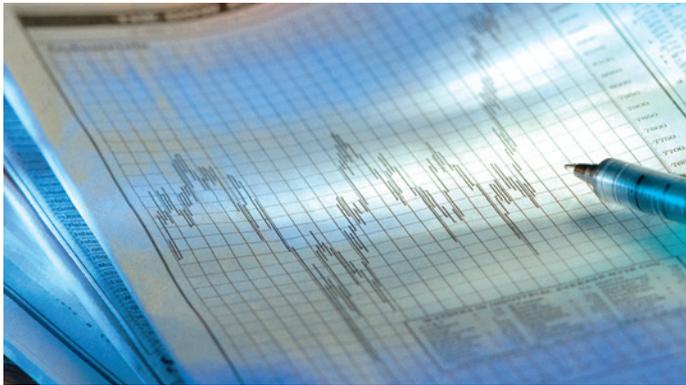


GoodQuarter

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"Games are won by players who focus on the playing field — not by those whose eyes are glued to the scoreboard."

— Warren Buffett

Dear Valued Client,

The first half of 2016 was a period of relative weakness for our client-held equities, while our corporate bond holdings performed admirably. Some of the weak equity performance was related to the Canadian dollar increasing in value. While not ideal, this comes after a 2015 calendar year in which the Canadian dollar weakened significantly, thus adding to the returns of our U.S.-dollar-denominated businesses. Our portfolio continues to operate well. Many of the businesses we own are expanding and continue to allocate capital wisely.

The minute-to-minute trading activity of public markets creates the false impression that business values continuously change. Occasionally, businesses can experience one-off events that affect their company's value, but these occasions are rare. More often, management takes deliberate steps – day in and day out – to continue to build their business, create pricing power and differentiate from competitors. The effects of these decisions take time

but the company's stock price should follow the growth of the business over longer periods of time. Unfortunately, stock returns are unpredictable and do not always reflect reality over shorter time periods.

On an administrative note, we would like to remind all our clients that monthly statements and trade confirmations can be viewed electronically. If you would like to receive your paperwork electronically rather than by mail, please contact Monica or Fuyumi at 416-488-8825 or email us at info@gfiic.com to let them know your preference. They will be happy to arrange this for you.

Thank you for your continued support. We are always available if you would like to discuss your investments or any other matter.

Daniel Goodman, CFA
President and
Chief Executive Officer

Effie Wolle, CFA, MBA
Chief Investment Officer

Stock returns: Focus on growth and capital allocation, not headlines

Why do stocks go up? Down?

Day-to-day, stocks increase and decrease in value based on whatever issues are dominating the headlines. The news is often related to central banks, interest rates and macroeconomic news from around the world. Often, these factors seem to dominate all other forces in moving stock prices. Unless a company has a specific issue to announce to shareholders, companies typically report to shareholders only four times per year, yet the stock market is open nearly every day.

This daily movement often leads to the perception that one has to have a view on the future direction of currencies, the Fed or any other topic “du jour” to invest in stocks. The truth is actually the exact opposite. It is, therefore, wise to take a step back periodically and remember that stocks are not just electronic ticker symbols that trade; they represent real ownership interests in a business.

Businesses, and thus their stocks, generate returns over time in response to some basic mathematics. To illustrate this point, let’s walk through an example of a fictitious company: ABC Restaurants.

ABC Restaurants has a share price of \$20.00 and earns \$1.00 per share. The company’s stock sells at 20 times earnings. The company can allocate its \$1.00 of earnings in a couple of different ways.



ABC Restaurants



Option 1: Allocating Capital to *Growth*

ABC Restaurants is a young company with growth potential and, thus, it reinvests all of its earnings into opening new restaurants. These restaurants earn a return of 12% on the capital used to open them.

After 10 years growing at 12%, the company will produce earnings per share of \$3.11. Assuming ABC still trades at 20 times earnings, the new share price will be \$62.20, providing a return of 12%.

If, instead, the company now trades at 18 times earnings, the stock price will be \$55.98, providing an annualized return of 10.8%.

While price/earnings multiple expansion or contraction is important, the effect of these changes is reduced over longer time periods. The main driver of returns is the company’s growth in earnings.

Option 2: Allocating Capital to *Shareholders*

ABC Restaurants decides that its restaurant concept does not scale very well. Thus it maintains its original restaurant location, leaves its earnings in cash and pays that cash out in the form of dividends to shareholders.

ABC would then have \$1 per share in cash each year, which it would return to shareholders. At the end of 10 years, the company would have paid out \$10 per share in dividends.

With ABC still trading at \$20, the result would be a return of 5% per year — assuming zero growth of earnings. Note that it is likely the company’s earnings would grow by at least the rate of inflation, but for the purpose of this example, we have kept earnings constant.

Hopefully we have successfully illustrated that a stock's return is based on two things: capital allocation, and the difference in its price-to-earnings (P/E) ratio at the time of sale versus the time of purchase. Since the company's P/E ratio in the future cannot be known, figuring out how a company allocates capital is the most important factor in distinguishing a successful investment. The holy grail of investment opportunities occurs when a company can grow without investing additional capital in the business. That frees up their capital to pay dividends, buy back stock, or pursue an acquisition while still growing organically. However, most businesses cannot grow without reinvesting capital in new plants, stores, warehouses, trucks or other areas that drive the growth of that particular business. Ultimately, companies that reinvest their earnings at high rates will perform well over the long term. Over time, P/E multiples become less important to the return of a portfolio. The P/E ratio will move up and down, many times for reasons unrelated to a business's value.

To reiterate, the best companies to invest in are the ones that can simultaneously pay out earnings in dividends and grow. These are the types of investments that we focus on identifying. It goes without saying that these companies are hard to find. That is why we spend our days scouring the potential opportunities available in search of these types of investments.



The daily news cycle

Over the last few months, the financial media has been discussing the potential ramifications of a United Kingdom withdrawal from the European Union (the "Brexit"). Stock markets moved up and down on a daily basis based on the most recent polls and pundit predictions. While the U.K.'s exit is a major political event, investors should not alter their portfolios based on this or any other political event.

From time to time, major political and economic events occur, but their economic impact on companies operating on a global basis is usually exaggerated and, with hindsight, often irrelevant. A few years ago, stock markets were similarly volatile in response to the impending financial crisis in Greece. And while we cannot compare the economies of Greece and the U.K., the larger point is that companies continue to produce goods, provide their services and adapt to whatever new reality emerges.

There are specific companies that may face material impacts to their businesses and profitability as a result of a U.K. exit, and these companies' valuations should indeed be impacted by Brexit. However, it makes little economic sense for the entire stock market to increase or decrease based on an event like this. This, of course, will not stop the ongoing discussion in the media. Our opinion on this matter is generally the minority view. Considering the number of events that have been blown out of proportion historically, we are confident that, in hindsight, investors will be happy they continued to hold quality equities in their portfolios through the various global events that have transpired over time.



GFI Investment Counsel

GFI Investment Counsel (“GFI”) provides tailored investment portfolios to families, foundations, trusts and corporations. We work closely with our clients to customize investment accounts that coincide with our clients’ unique requirements. GFI focuses on preserving and growing client capital through intense due diligence, focus, and discipline.

In January 2008, GFI launched Good Opportunities Fund (“the Fund”), an alternative investment fund available to accredited investors. The Fund focuses on a select group of investment opportunities that provide an attractive risk/reward dynamic regardless of asset class or market capitalization. The Fund is managed with a focus on understanding the businesses, their capital structure, and risks and opportunities.

For more information about GFI Investment Counsel or the Good Opportunities Fund, please call **416.488.8825** or email info@gfic.com.