Written by Tye Bousada

This is not a step

I was painting a wall in my house last week and the job required a stepladder. As I climbed to the top of it, I noticed that the top rung had the following warning pressed into the aluminum: “THIS IS NOT A STEP”. I suppose the company that manufactured the ladder believed that some people, in a quest to get their job done, might actually climb onto the top step, exposing themselves to an extreme amount of risk. This simple warning made me think about a conversation I had earlier in the day with Greg Lagasse, one of EdgePoint’s 23 internal partners. Specifically, Greg called to talk about the market’s unquenchable thirst for yield.

As it has been well documented, there is a demographic shift going on that has led to a massive swelling of retirees. This retired cohort requires income from their investments to live on. Unfortunately, given the current global interest rate environment, it is very difficult for this group to find yields that are sufficiently attractive. As such, many individuals are investing in products today solely based on their current yields and may not fully appreciate the risks associated with achieving these yields.

Yellow Pages Income Fund

Let’s use an example to demonstrate this point. Yellow Pages Income Fund (YP) has an annual dividend yield on their units in excess of 12%, making it quite attractive to someone in search of income. YP is Canada’s largest directory publisher whose printed products reach 93% of our country’s population. This dominant position provides the company with industry-leading margins and profit which, in turn, has enabled it to take on a material amount of debt. Its debt level stood at $2.3 billion as at December 31st 2009, excluding unfunded pension liabilities and preferred shares. However, instead of using the majority of its cash flow to pay down this debt, YP opted to pay out a very large dividend, resulting in its high yield.

If you are under the age of 25, there is a high likelihood you use Google or other such websites to find information that someone historically would have sourced from the Yellow Pages. For those who are close to the age of 40 (which I am), there is a good chance that you grew up using the Yellow Pages. And if your home was anything like mine, the book sat firmly under the rotary phone in the kitchen. These big yellow books were once a staple in most homes. Nonetheless, even those close to age 40 are finding it easier to use the internet to locate their local drycleaners or auto body repair shops. As a result, there is a material probability that YP’s business model could be permanently impaired over the next 10 years as their strangle hold on local business inquiries is slowly eroded.

Let’s walk through why this might not be favourable for owners of YP units. Owners of YP may be looking at their units through the same lenses as they might look at a 10-year government bond. Their thinking is that a 10-year government bond will pay approximately 4% a year for the next 10 years versus YP, which currently pays over 12%, making YP look far more attractive. The big difference, however, is the likelihood of getting your initial investment back after 10 years. If the trend towards internet local searches continues and YP’s market share loss accelerates, then its business could easily be worth less in the future than it is today. In such a scenario, what would the value of your investment be?

Stated another way, the government bond represents a return ON capital, whereas, YP's "yield" could potentially be a return OF capital. There is an extremely high probability that government bond investors, who are collecting 4% a year in yield, will get their full principal returned to them in 10 years when the bond comes due. However, an investor in units of YP might not be so lucky. If competition continues to result in fewer people using YP's services, its revenue will shrink, which in turn will hurt its high margins and operating profit, which in turn will hurt its profitability, which in turn will hurt its ability to maintain its dividend payments. There is the potential risk that in 10 years from now, YP's value could conceivably be only a fraction of what it's worth today. The YP investor may be reaching for yield by standing on the top rung of the ladder. The 12% yield gets the job done today, but the investor may be risking his or her long-term wealth to do it.

We should note that we have no idea whether YP's unit price will be higher or lower in the future. We haven't studied the potential risks facing YP well enough to have conviction that the business will be worth less or more in the future. The point that should be taken away from the preceding discussion is that it is dangerous to own a company strictly for its yield without fully understanding the underlying business risks facing the business.

At EdgePoint, we believe the appropriate way to grow capital is to acquire an ownership interest in a high-quality business that can grow its value over time. We strive to buy this ownership stake at a price below our assessment of its true worth. The best way to do this is to have an idea about the business that is not widely shared by others - what we refer to as a proprietary insight. We strive to develop proprietary insights around businesses we understand. We focus on companies that have strong competitive positions and defendable barriers to entry, strong long-term growth prospects, and are run by trustworthy and competent management teams. At times, we have the opportunity to buy businesses whose common shares are paying out high yields, while at other times we do not. What guides our final investment decision when selecting equity investments, however, has nothing to do with yield and everything to do with the preservation and growth of capital.

Investment approach at work: EXFO, Inc.

EXFO, Inc. is an example of this approach at work. Approximately one year ago, we could have purchased YP, which had a 12% dividend yield, but we decided to purchase EXFO, which had a 0% yield. Why? Our investment thesis on EXFO is based on the idea that they sell equipment to companies that deploy fibre optic networks globally, and we believe fibre optic networks are the future backbone of the internet.

Global internet traffic is expected to grow at a compound annual rate of 40% per year for the next five years. Stated another way, internet traffic will be five times larger five years from now than it is today. In order to accomplish this, larger digital highways need to be built. We believe the most efficient and economic digital highways are made with fibre optic technology. Although they are the best, their deployment into homes is still in the very early stages. Specifically, only two countries in the world (Japan and South Korea) have more than 10% of their households hooked up to the internet through fibre. This low penetration rate has resulted in global growth rates in the deployment of fibre in excess of 50% per year. This benefits EXFO as it sells equipment into this fast-growing market. Specifically, it is a global leading-provider of test and service assurance solutions for network operators and equipment manufacturers.

During the period of April through August of 2009, we were able to buy EXFO below $4 a share. At the time, the company had $1 a share in net cash, which meant we were essentially buying the company for below $3 per share. We estimated EXFO's normalized earnings could be in excess of $0.50 per share. Therefore stripping out the cash, we were receiving a 17% earnings yield on a normalized basis (or paying the equivalent of six times earnings). In our judgment, this was an attractive price to pay for a company that had a leadership position in a market growing over 50% a year. When we compared this to collecting a 12% dividend yield from YP and its uncertain future, EXFO, in our judgement, presented a much better investment opportunity with less risk. Since that time, EXFO has appreciated to above $6 per share while units of YP are trading at approximately the same price as they did last April. It's important to note that this comparison is done over a very short period of time and that our goal is to build wealth for you over a 10–year period. However, we believe this example demonstrates the important difference between investing for growth at a value price as opposed to reaching for yield from the top step of a ladder.

Fixed income comments

North American fixed-income markets were relatively immune to the risk aversion seen in Europe that was brought on by Greece's struggle to issue new debt. Corporate bond spreads continued to tighten throughout the first quarter of 2010.

There are significantly fewer opportunities in the corporate fixed-income market compared to this time last year, however, we have been able to participate in numerous new issues and continue to uncover solid businesses that are trading at attractive levels. Corporate bonds continue to make up the entire bond component of the portfolio. As with all our investments, preservation of capital is our primary concern and we are focused on not taking unwarranted risk in search of higher yield. We have confidence that we will find opportunities where the market is mispricing securities and will invest with conviction behind these ideas.

In summary, we are pleased with the collection of businesses in your portfolio and excited about your businesses' long-term prospects. We continue to approach investing in these markets with a sense of measured confidence. We thank you for your confidence in us, and look forward to having the opportunity to build wealth for you over the long term.

Sincerely,

Tye Bousada

Tye Bousada

Commentary as at March 31, 2010. The above companies are selected for illustrative purposes and are not intended to provide investment advice. EdgePoint Investment Management Inc. may be buying or selling positions in the above securities.

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