

The irresistible pull of fear

By Tye Bousada, portfolio manager

You've invested your money with EdgePoint because you're saving for something. Maybe it's for retirement, or your children's education or a new home. While this money is invested, every day the media pushes out what feels like a relentless stream of bad news about the global economy. This has created enormous share price volatility. In fact, this August and September proved two of the most volatile months ever in the stock market. You look at this volatility and wonder if it represents a risk to achieving your long-term goals.

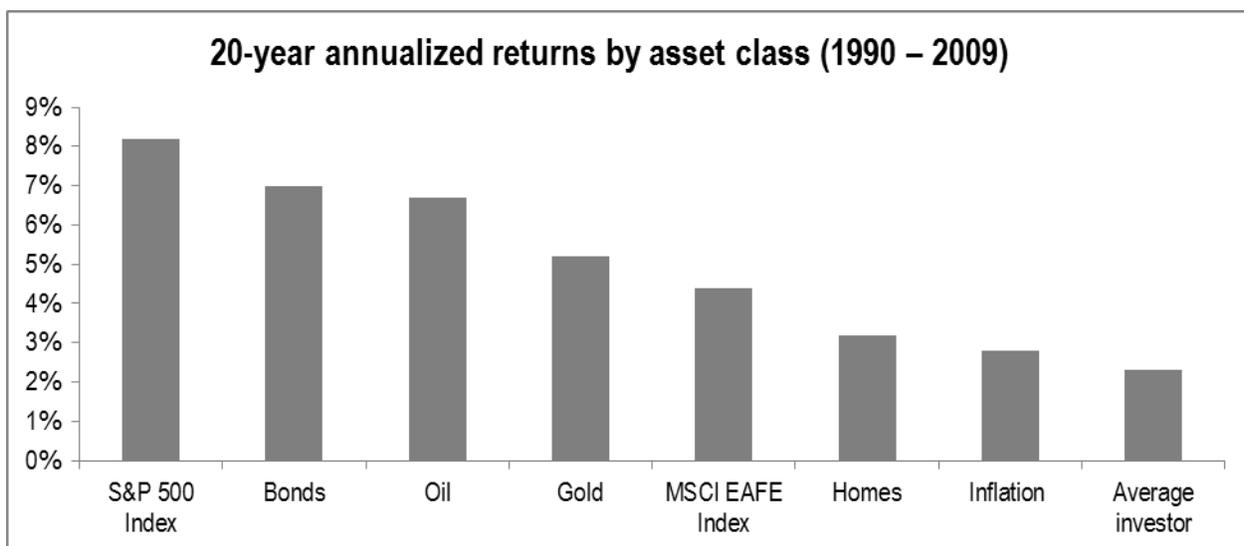
At EdgePoint, we don't believe volatility is risk – no matter how uncomfortable it is. The reason is our time horizon. What does this mean? Well, if, for example, you need your invested money in the next three months to make a mortgage payment, then we agree that short-term volatility can be a real risk to you. However, we're not investing for the next three months. Our investment horizon is much longer. Specifically, our goal is to deliver performance at or near the top of our peer group over a 10-year timeframe. Since launching almost three years ago, your EdgePoint portfolio has materially appreciated in value. In retrospect, these results are pleasing in absolute and relative terms; still, it's been just shy of three years. More to the point, your portfolio's trajectory in attaining these results hasn't been linear. Over its short life, your portfolio has experienced its fair share of volatility. As portfolio managers, we've embraced this volatility. It's a friend to investors who know the value of a business and an enemy to those who don't. Historically, chaotic periods in the market are when we've added the most value for you.

If volatility doesn't represent a risk to achieving your long-term goals, what does? We believe it's two things: The opportunity for permanent loss of capital and the opportunity costs created by the irresistible pull of fear.

Let's start with permanent loss of capital as this is the ultimate risk. At EdgePoint, we follow a time-tested investment approach that has historically helped us avoid permanent loss of capital. The approach is based on common-sense principles such as: Do your homework on a business before committing capital to it; Invest only in businesses that you understand; Invest only when you see something about a business that others don't, allowing you to buy a stake far below what you think it's worth; and avoid investing in line with consensus.

The second definition of risk is the opportunity costs arising from the irresistible pull of fear. The following graph highlights the damage done when the average investor succumbs to emotional investing.





Source: JP Morgan, Bloomberg. Bonds: Barclays Capital U.S. Aggregate Bond Index; Oil: Bloomberg WTI Cushing Crude; Homes: S&P/Case Schiller U.S. Home Price Index; Inflation: U.S. Consumer Price Index; Investor returns: Calculated using Dalbar fund flow information. Annualized returns in US\$.

Fear causes emotional investing and unfortunately, emotional investing causes your worst fears to come true. Stated another way, short-term volatility and the worry surrounding it leads people to make decisions that result in them not achieving those aforementioned long-term goals.

Today, the average investor has many things to be fearful about. The European debt crisis and a potential Chinese slowdown seem to be at the top of the list and deservedly so. Unfortunately, we don't know how the situation in Europe will be resolved or what China's GDP growth will be next year. We don't think anyone in the world actually does. We do understand that issues like these represent headwinds to future global growth and have been saying as much for the last three years.

How do we invest in this type of environment? First, we try to operate in a narrow emotional band. Second, our job isn't to guess the future, but rather to be prepared to deliver superior long-term performance under a wide variety of outcomes. Faced with material headwinds in the global economy for years to come, we think the best course of action is to find businesses that can grow irrespective of what happens in the economy, within a band of reason. We try to avoid situations that depend on macro issues being resolved in order to make money over the long term.

With all of the negative headlines, it's at times difficult to believe that commerce continues or that it might be possible for a company to grow in today's environment. In spite of this, since the inception of your portfolio, we've been able to find exactly these types of companies.

Let's talk about an example: Intact Financial. Intact is the largest property and casualty (P&C) insurer in Canada – think auto and home insurance. How do P&C insurers make money? They're in the business of taking \$100 from you at the beginning of the year in the form of insurance premiums and then paying out \$95 during the year in the form of accident claims. Furthermore, while they're waiting to pay out the \$95 for your eventual accident, they invest your \$100, to their benefit. Not only do they take more money from you at the beginning of the year than they pay out to you at the end, but they make money on your money all year long. Sound too good to be true? Oftentimes it is. Few P&C companies have demonstrated a consistent ability to operate in this fashion. Most P&C companies pay out more at the end of the year than they take in at the beginning, hoping to break even with the proceeds from their investments.

Intact is different. The company has a long-term track record of profitable operations. In fact, since 2003, Intact has paid out less than it takes in and has made good returns on that money in the interim. Intact has achieved this due to its relentless focus on lowering costs and its scale advantage. As it relates to scale, being the largest player in Canada allows Intact to draw on a larger database of insured risks to better forecast future losses. In turn, this leads to more effective pricing, which leads to higher profits. We originally purchased Intact in early 2009. Since our original purchase, the company's profits have increased by over 50% and its share price has almost doubled.

Now, ask yourself the following questions:

- If Greece defaults on its debt, are you going to give up your car insurance in Canada?
- If growth in China slows, are you going to let your home insurance lapse in Canada?
- Assuming you answered no to these questions, would you rather purchase insurance from a high-cost provider or a low-cost one?

Regardless of the macro concerns facing the world, Intact should continue to do well. More people will buy insurance next year in Canada because of population growth. A new car will cost more to replace next year than this year and, therefore, premiums to insure that car will increase. Finally, Intact will continue to take share due to its more effective pricing strategy.

As it relates to valuation, Intact is trading for about an 8% free cash flow yield. That means if we owned 100% of this business, our first-year return would be 8% before growth. Assuming Intact can grow in the future at the same rate that it has in the past, our total return should be above 10% annually over the long term – even if macro headlines continue to give rise to volatility. We don't believe that return will happen smoothly. Short-term volatility will move the share price

around a lot. But longer term, Intact should deliver attractive returns just like they have in the past.

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

Sincerely,

Tye

Fixed-income comments

By Frank Mullen, fixed-income and equity analyst

The quarter was extremely active for the fixed-income allocation of the Portfolio. Broad volatility coupled with the decline in equities negatively impacted North American credit markets. High-yield spreads widened by over 200 basis points (bps – a basis point is 1/100 of a percentage point) during the quarter (based on the Citigroup High Yield Market Index). On average, Canadian investment-grade spreads widened by approximately 50 bps. This volatility presented us with the opportunity to purchase several new positions and add to existing bonds that we'd been monitoring but that had become increasingly expensive. The negative sentiment caused many bonds to fall in price despite strong underlying business fundamentals, increasing yields to levels we felt were attractive.

The yield of the fixed-income portfolio increased materially as we allocated more capital toward investment-grade and high-yield bonds, as well as convertible debt securities. This increase was achieved without a corresponding increase in duration risk, also known as interest rate risk. We established a new position in Newalta bonds maturing in 2017 at a yield of 7%. We own the equity in this business and feel confident that the company can grow despite economic headwinds. Newalta is one of the largest providers of oilfield and industrial waste services in Canada with the ability to enter new markets and generate strong returns on invested capital.

We also significantly added to our position in Alere bonds maturing in 2016 at a yield of 8%, taking advantage of an opportunity created by a selloff in the equity that we felt was unjustified given the strong business fundamentals. This is another example of how we leverage our equity research as we own the company's common shares.

We'd been waiting patiently to add to our fixed-income holdings, and the early August market volatility created excellent opportunities for us to deploy funds into quality investment ideas. Having a strong understanding of the businesses' underlying credit fundamentals allowed us to respond quickly to the market weakness. Volatility is a friend to investors who know the true value of a business.

Sincerely,

Frank

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