

The world is coming to an end...again

By Geoff MacDonald, portfolio manager

This is the 12th quarterly commentary I've written since we began almost three years ago. My very first one set the tone for the next 10 and likely the 10 thereafter. In that inaugural commentary, I suggested investors not fear the opportunity brought by lower prices. I repeated the message in my 2009 and 2010 year-end commentaries. For three years now, we've risked sounding like a broken record by consistently writing about how pessimism has led to an unwillingness to pay for growth potential, giving investors opportunities to buy companies whose future growth prospects aren't reflected in their current stock prices. Since its inception, the Portfolio has grown by 38.6% (Series A), hopefully showing that a market full of pessimism isn't one without money-making opportunities.

Though unfortunate, it's no wonder our message hasn't changed. We've frequently warned that things will likely be slower for longer and are still saying that today. Don't misunderstand my use of "unfortunate." It's only because as a writer of quarterly commentaries, it'd be nice to have something different to talk about. In fact, a market full of pessimism is one of the most fortunate things for investors to stumble upon.

Over the past three years, we've capitalized on many occasions to buy businesses from people chock full of pessimism, opportunities that continue to present themselves. These pessimists are who you must always try to find if you want a successful career purchasing businesses. I don't want to downplay the concerns we all have regarding the future. However, I'm wary of losing sight of the entry price, which dictates future returns and is easier to get right when buying from depressed, scared, uninformed or pessimistic sellers.

This is the fourth time in three years that stock market participants have thought the world was coming to an end (with November 2008, March 2009 and the summer of 2010 being the last three). Each end-of-the-world event allowed us to pick up businesses that later returned substantial profits.

Macro, macro, macro. Doesn't anyone buy companies anymore?

The crowd's attention to macro concerns has rarely been greater – something seasoned investors love to hear.

I suppose it's more fun to focus on macro issues and pontificate with others about the embarrassing political show in the U.S., or the likely direction of the euro, or whether French



banks will go bankrupt, or China's slowdown, or gold's rise, or the operation twist, or the likelihood of a double-dip recession or Greece's future in the European Union. Luckily, almost every business publication spends the vast majority of its effort on the same topics as everybody else. This makes it easier to read and talk about the same things as everyone else.

Is there even one person in this crowd of millions who thinks they have some insight that no one else reading and talking about the same thing has? If so, this person must be exceptionally smart. Remember, without unique insights, your investment prospects are weak. Though macro discussions are entertaining, we shouldn't forget to collect the five-dollar bills on the sidewalk while we theorize on such matters.

It's okay to have macro world views. Everyone does, including us. But it's also possible to get caught up in the noise and miss wonderful investment opportunities along the way. Most importantly, macro views must be contrasted with what's already been discounted by the market. For example, in 2000 the crowd preached the wonderful investment opportunities of the internet. If investors agreed and then realized no one had a unique insight since everyone saw the same future, they could've avoided capital loss. For example, it's okay to agree that there's a chance of a double-dip recession in the U.S. But remember that if everyone agrees with you, then stocks are likely to discount that probability and you should be investigating potential buys, not sells. As an example, the free cash flow yield of the S&P 500 Index relative to 10-year treasuries hasn't been this wide in over 50 years, underscoring the pessimism already discounted in current prices.

There are two big problems with macro views. The first is that you could be wrong. What if you design a portfolio based solely on one macro view or one fear and it's the wrong one? Effectively, your entire portfolio could be wrong and you just might experience your very own lost decade. The second problem is that even if your top-down view of the world is accurate, it might bias you away from incredible investment opportunities.

For example, we look at Europe with great disappointment that they've dithered as much as they have since 2008's credit crisis. For global fund managers, we've had a disproportionate few investments in Europe for the last three years. Europe didn't recapitalize its banks when it had the chance. Not only that, but those banks didn't change the nature of their funding (they're still just as reliant on short-term, wholesale funding as before). Europe now has weakly capitalized banks holding suspect assets that are getting their funding pulled. Should anyone be shocked about the potential for European banks to fail? Throw on top of this mess 17 self-interested countries seeking a unified solution. Add to it that many of these countries were at

war with each other not too long ago and it becomes almost humorous. Then attach a toothless central bank, countries taking on more debt to help bail out weaker countries adding to their debt, plus the huge productivity differences between nations and you see why we have a fantastic show that, for the most part, should be watched from the sidelines.

Perhaps everyone feels equally discouraged by Europe's prospects. If so, that doesn't mean everything in Europe is a great investment but likely means businesses are, for the most part, attractively priced. Given our view of the problems across the pond, we're likely wise to continue to stay away from European banks. Perhaps we should also avoid companies domiciled in the weakest countries, such as Greece. The nature of capitalism in Greece for the next 10 years could be much different than it was for the past 10 years, with huge tax increases, nationalizations or even a depression. Who knows?

Nevertheless, are there companies operating in European jurisdictions where the nature of capitalism likely won't change much over the next decade? Companies that can grow even in the face of Europe's many hurdles? Can they steal market share, launch new products or move into new markets despite economic headwinds? While this might describe only a minority of companies, even the biggest macro bear would likely agree they exist. Since these companies exist and we've acknowledged it's unlikely they're expensively priced, this is a spot to run towards, and not from, to find opportunities. It shouldn't surprise you that we recently started to build a position in a company from Europe, a name we should be able to tell you more about soon.

The point of this ramble on Europe has nothing to do with Europe per se. It's aimed at highlighting the notion that even though investors may be worried and have negative world views, good investments can still be found. Provided capitalism doesn't change substantially in your investing jurisdiction, purchasing a company at a reasonable price that can grow is always a sound idea. Such companies may be a rarity depending on your perspective. But they exist. Don't let all of the macro distractions cause you to miss these gems. These gems have grown in value over the past six months, and that's not lip service. Over the same period, EdgePoint employees have invested well over \$1 million of their savings in EdgePoint-managed portfolios. These purchases are above and beyond our monthly company RSP plan contributions.

Sincerely,

Geoff

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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