Second-level thinking

By Geoff MacDonald, EdgePoint portfolio manager

Since we launched our portfolios at EdgePoint, we've talked about the likelihood of things being "slower for longer." We didn't arrive at this prognosis using a crystal ball. There simply seemed to be enough headwinds in the world that it was only prudent to invest our money in a manner that would be successful even if things were slower for longer (after all, EdgePoint employees are the single-largest investor in EdgePoint's Portfolios).

Now, believing things could be slower for longer didn't require much unique thinking. In fact, we've been met with dramatic consensus every time we've suggested that things could be slower for longer. Based on this, and the fear and worries we've witnessed in the marketplace over the past few years, the majority of investors were also investing as if things would be slower for longer.

Before I continue, I want to stress that we have zero desire to be average. Firstly, considering today's interest rate levels and the various potential economic headwinds (e.g., the chance that multiple governments go bankrupt, China's investment bubble, etc.), "average" will likely meet few of your investment goals over the next decade. Secondly, if we simply desired to deliver average returns, we'd invest your money similar to the index. We'd own a little bit of everything and be perfectly average. But we don't raise our kids to be just average nor did we start this company with that desire. In fact, one of our three goals when we founded EdgePoint (which we've featured on our website since day one) has been to achieve investment results at or near the top of our peer group over a 10-year period. Thus, we desire to win over the long term.

If we added zero insight to the above prognosis, we'd likely invest where almost everyone else did in this slow and uncertain environment: in obvious survivors (e.g., consumer staples, utilities, pharma companies, etc.). We also would have caught the wave and focused, like most everyone else, on dividend stocks. If the outlook is uncertain, "getting paid to wait" on the surface seems rational. It seems even more rational if you're trying to sell an investment product. Outperforming over the long term requires much more than such a simple level of thinking.

Long-term outperformance requires insight not readily available or used by others. Though that might sound obvious, we find it's the minority of investors who spend most of their time looking for insight not widely shared or understood.

In a recent book entitled, "The Most Important Thing," Howard Marks, the legendary chairman and co-founder of Oaktree Capital Management, talks about this very topic. He calls it "second-level thinking." We've always called it *proprietary insight*. Here's an excerpt from the book's first chapter:

"First-level thinking says, 'It's a good company; let's buy the stock.' Second-level thinking says, 'It's a good company, but everyone thinks it's a great company, and it's overrated and overpriced; let's sell.'

First-level thinking says, 'The outlook calls for low growth and rising inflation. Let's dump our stocks.' Second-level thinking says, 'The outlook stinks, but everyone else is selling in panic. Buy!'"

Let's look at recent examples of adding insight instead of falling into the trap of simple-level thinking:

Yellow Media

Simple thinking: It has a great dividend yield and is a good business. That high yield should support the stock.

Insight: Our kids will never know what that heavy yellow book was except from history class. When they grow up and need a good plumber, they'll ask their friends on Facebook for a suggestion or perhaps search on Google. It's unlikely they'll visit yellowpages.ca. The company has almost $3 billion in debt standing ahead of its owners, meaning for this business with a suspect future to be worth even a dollar, it would first have to be worth $3 billion.

The current environment/slower for longer/uncertain outlook

Simple thinking: Buy investments with little perceived risk. Cash is good, bonds are safe and high-dividend-yielding investments such as pipeline stocks are also attractive. Please read my previous commentary to learn about the traps and likely unsatisfactory investment outcomes for those who've flocked to safety.

Insight: If things truly are slower for longer, will average investments meet your long-term investment goals? Do investments with little perceived risk offer the chance for much of a return? Instead, let's look where others aren't excited, like to the future. If people aren't excited about it, isn't it possible to buy and not pay much for future growth? Think of the money we can make if we find a company able to grow and buy it at a price that's discounting no growth because people aren't excited about the future.

The importance of growth

If things are truly as tough as some people think, then growth is important and everyone should struggle to find some.

Think about how inflation could eat the returns of those 3% – 5% bonds and slow-growing "safety stocks." A slow-growing company in an inflationary period can be just as bad as a bond. Getting your money back in 10 years from a stock or bond is no victory, even if you clipped 3% – 4% annually. Now, think about owning a business that could be two-to-three times its size in 10 years. Purchased at the right price, that company might help you fight the evils of inflation.

What about an environment where global economies barely grow? Then, even an average company purchased cheap might not help you. Can an average company grow if the economic headwinds are sufficient? What about the 50% of companies in all indices that by definition must be below average? Think again about that business that could be double its size or bigger in a decade. Purchased at the right price, won't it make you a lot wealthier?

To illustrate the importance of growth, let's take a quick example of two companies: Company A and Company B. Company A grows its earnings 15% yearly over the next decade. Company B is in a safe and secure industry, but grows its earnings 3% a year over the same period. Let's assume you can buy both companies at a price that corresponds to 12X earnings (in other words, if a company makes $1 you pay $12 to own it).

It's reasonable to assume that both companies can be purchased at the same valuation (12X earnings) because as I mentioned, investors have put a premium on slower-growth companies that offer short-term certainty.

For both companies in our example, let's assume their earnings simply accumulate on their balance sheets as cash that we'll add to their value in 2022, which will still be 12X earnings. You have a choice to invest $10,000 in either company.

In 2022, your $10,000 invested in Company A is worth $66,300 while the $10,000 invested in Company B is worth only $23,700.

Receiving $23,700 in a decade from an initial investment of $10,000 isn’t shabby; however, if you're interested in outperforming, Company A is your solution.

I hope this example shows how getting growth for free – and using second-level thinking – can help you to outperform.

RIMM

It would be tough to complete a second-quarter commentary without mentioning Research In Motion (RIMM). As you probably know, we've had a view on RIMM shared by few over the past couple of years. Though I wrote in my last commentary that we took profits in RIMM, we were still a large shareholder going into the quarter. Perhaps consensus will prevail with RIMM (every now and again, the crowd gets one right!). We still contend that RIMM has a real shot at being a strong player in a massive future market where most have failed, but there are obvious risks in getting there. The future is mobile computing and RIMM has put itself in the center of it.

The likely future technology spending at our company highlights the trend. The thought of our salespeople asking for a new laptop or computer over the next five years because of a new version of PowerPoint or Excel is laughable. Spending on computers and laptops will drop substantially relative to spending on

smartphones and tablets. Where's Dell or HP and how did they miss this? What about Intel? With a potential failed last attempt with Nokia in the fall, won't Microsoft miss this too? Speaking of Nokia, how could they have not seen this?

Motorola, Samsung, LG, Sony and HTC have all given up and been forced to accept an Android operating system inside their box to keep them alive in this space. How do they differentiate when they're all embedded with the same operating system? They must all plan to have the shiniest box. Yet they can't all have the shiniest box. We're fairly certain that value in this industry will accrue to those who own the operating systems empowering smartphones and tablets. Today, the only legitimate players are Apple, Android and Blackberry (with its QNX operating system). Perhaps Microsoft will make a comeback with Nokia. Time will tell, although that time is running out. Regardless, mobile computing is huge and there are currently only three companies vying for a slice of the pie. For RIMM, being one of those three doesn't guarantee success. The future, though clear in terms of size, is still uncertain in terms of the winners.

There's no doubt that while we were taking profits on this stock in the first quarter of the year, we should have sold our entire position. We didn't because we were focused on the company's long-term potential. If RIMM takes just a small share of this wonderfully large future market, it will grow substantially in value.

Though it's impressive that a little Canadian company is in the middle of the future of computing, they've made some missteps along the way. The result is a short-term gap in their product offering as they bridge over to new devices and software. Though we recognized this issue and took some profits earlier, we never would've guessed market reaction would be so harsh. Our mistake was in not selling more last quarter when we had a chance at much higher prices.

Should RIMM fail to be one of the few survivors in this large market (remember, they already have 68 million subscribers), we don't believe it will be because of inferior technology. More likely it will be due to communication shortcomings. The Blackberry brand, once truly aspirational, has weakened drastically in certain circles and in certain countries.

Management's failure to properly articulate the Blackberry network's many positive attributes (including security, network efficiency, etc.) and, more importantly, tout their impressive QNX operating system, might ultimately cause their loss of mind share. We're continually reminded that Betamax was superior to VHS, yet VHS won. Our best guess of the future continues to be that mobile computing won't accrue to just one player and that RIMM will be a survivor.

As an aside, I wrote this commentary on my Blackberry Playbook while traveling. At home – collecting dust – is my Dell laptop with its Microsoft operating system.

Sincerely,

Geoff

Fixed-income comments

By Frank Mullen, EdgePoint fixed-income and equity analyst

We're finding it increasingly difficult to identify attractive fixed-income investment opportunities that don't require us to incur high levels of risk. Investors' strong demand for yield and their perception of the safety in most bonds continue to push valuations to levels where we don't feel the potential return justifies the inherent credit and interest-rate risk. This environment has caused us to be more defensive in our fixed-income allocation and position the portfolio to have relatively low interest-rate exposure compared to the BofA Merrill Lynch Canada Broad Market Index, a broad-based Canadian fixed-income index. While we remain 100% invested in corporate bonds and feel that select corporate spreads are attractive, the majority of our bonds are under five years in maturity.

Over the past year we've done significant research on the energy service sector, focusing on how new technologies will alter the way oil and gas reserves are recovered. We've made several debt and equity investments in the sector and have a solid understanding of the future business drivers.

We began researching a new service company called Forbes Energy Services during the last quarter. They provide services to the oil and gas industry in the developing Eagle Ford basin, located in the U.S. Forbes built their business in Texas years before investors started focusing on the Eagle Ford basin, where new oil and gas drilling technologies have dramatically increased the potential oil and gas supply. It was our opinion that Forbes' strong competitive position would lead to material increases in demand for their services as exploration and production companies began to explore the area. We were also confident in our ability to value their core assets because we're familiar with the sector and have invested in similar companies in the past. The company's strong asset coverage and potential to increase cash flows from new sources of demand were key reasons for us to consider this investment. Furthermore, our analysis of the bond indenture led us to believe that management would likely call the bonds at a premium to remove the onerous covenants that restricted its ability to build new assets and grow the business.

We purchased Forbes 2015 bonds at $106.75 with a yield of 8.87%. In a short period of time, we saw improvements in the business that were consistent with our investment thesis. Also, management called the bonds from us at a premium in early June at $112.75. The investment resulted in a holding-period return of almost 7% in less than two months' time. Investments like this highlight our ability to add value through in-depth credit analysis despite a low-yielding fixed-income environment.

Sincerely,

Frank

Commentary as at June 30, 2011. The abovementioned companies were selected for illustrative purposes and are not intended to provide investment advice. EdgePoint Investment Group may be buying or selling positions in the above securities. Commissions, trailing commissions, management fees and expenses may all be associated with mutual fund investments. Please read the prospectus before investing. Copies are available at **www.edgepointwealth.com**. Unless otherwise indicated, rates of return for periods greater than one year are historical annual compound total returns including changes in unit value and reinvestment of all distributions, and do not take into account any sales, redemption, distribution or optional charges, or income taxes payable by any securityholder, which would have reduced returns. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. This is not an offer to purchase. Mutual funds can only be purchased through a registered dealer and are available only in those jurisdictions where they may be lawfully offered for sale. This document is not intended to provide legal, accounting, tax or specific investment advice. Information contained in this document was obtained from sources believed to be reliable; however, EdgePoint does not assume any responsibility for losses, whether direct, special or consequential, that arise out of the use of this information. Portfolio holdings are subject to change. EdgePoint mutual funds are managed by EdgePoint Investment Group Inc., a related party of EdgePoint Wealth Management Inc.

Published July 6, 2011.