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The cover image shows luxury cruise ship National Geographic Endeavour II on voyage in the Galapagos Islands, Ecuador. The boat is managed by Lindblad Expeditions Holdings, Inc., one of our bond holdings in the EdgePoint Portfolios. It manages a fleet of 15 ships (10 owned and five leased) in partnership with National Geographic, along with several land-based ecotourism companies. Lindblad has been a carbon-neutral company since 2019.

Photo credit
Lindblad Expeditions/Ralph Lee Hopkins

Temperamental

By Derek Skomorowski

The "buy everything" rally, they call it. Or the "Santa Claus" rally at this time of year.

After all the recession talk, doomsaying on banking crises, tightening financial conditions, hemming and hawing over "unsustainable hawkishness" and "crushing policy," here we are sailing into the new year with a buying frenzy that makes you wonder – was Santa stuffing stockings with stocks this year??

Of course, it's fun making money in these buoyant markets, but for anyone looking to generate attractive *long-term* returns – returns that last longer than, you know, a few months – it's kind of the opposite of what we should hope for. Your EdgePoint Portfolios crave uncertainty and capitalize on volatility. Cheery conditions can leave a guy with a lingering grumpy face through the holidays.

But these conditions are a snapshot in time. This past year was, well, *fun*. A lot of fun. The past 12 months had more than their share of ups and downs. It's easy to forget we had a similar "buy everything" rally in January to start the year, and markets were bumping along at all-time highs through the better part of summer. In both instances, the frothy conditions didn't last, and ripe buying opportunities were right around the corner.

Not every dollar is equal

We get a lot of questions about our high cash balance and its potential to drag on returns. This elevated cash balance exists across all your EdgePoint Portfolios with fixed income holdings – the Growth & Income Portfolios, where it's referred to as "cash and other net assets"; the Monthly Income Portfolio, where it's bucketed primarily with "short-term government bonds"; and our flagship opportunistic credit portfolio (not the actual name of the Portfolio but you can read all about it here), where it's simply called "cash." We thought we might clear this up.

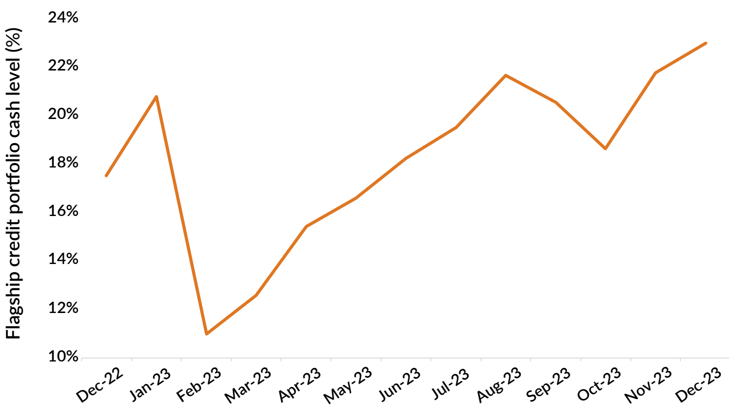
For starters, we no longer operate in a world where cash is "dead money" – cash today has a yield. Unlike cash in your chequing account, cash in our Portfolios generates a return very close to 5%, primarily by buying very short-term government treasury bills and bonds (note that these are the only instruments we accept as "cash equivalent." High-interest bank accounts don't cut it). No doubt, the decision to part with cash in favour of some other investment requires greater scrutiny when cash itself yields about 5%.

But in our view, *our* cash will deliver *far* more than simple cash. Our cash is our immediate stockpile of dry powder. It represents optionality, and the flexibility to aggressively pursue opportunities at the moment market participants who lack a clear understanding of what they own start running for the exits. It allows us to act quickly and decisively at the first sign of dislocation. It's not a suppressant – it's an accelerant.

The progression of cash within our flagship credit portfolio through 2023 is case in point. We started the year with about an 18% cash balance, which, in isolation, could have been a material headwind to our return. The balance only grew as markets rallied in January. But in February and March, when contagion around Silicon Valley Bank, Credit Suisse and the broader financial system led to a bout of selling, more than 10% of the fund was deployed in the market. Rebuilding our cash through the summer, we became aggressive toward the end of October as fears of rising rates created gift number two.

Cash levels of EdgePoint's flagship credit portfolio (which you can read about here)

Dec. 31, 2022 to Dec. 31, 2023



Seth Klarman, CEO of Baupost Group, has been known to operate his hedge fund with a cash balance in the lofty range of 30% to 50%. Given a 30-year head start trying to articulate his thinking around cash, it's worth borrowing this quip: "Why should the immediate opportunity set be the only one considered, when tomorrow's may well be considerably more fertile than today's?"[i]

The snapshot of the investible universe on this very day isn't the only universe we have to consider. We need to balance all opportunities that may present themselves over the coming weeks and months, while also acknowledging that as interest payments and bond maturities accumulate, credit funds are constantly producing more cash. In building cash, we're making a statement that we expect future opportunities will either add to the return potential of the Portfolio or reduce its risk by diversifying into positions with no relation to current ideas. Otherwise, we would just add to the investments we already own.

It's unlikely that our cash will rise much beyond current levels, but it's also not burning a hole in our pocket. Through 2023, despite having a cash weight that averaged about 18% in our flagship portfolio, combining the 5% cash yield and active deployment in turbulent periods, the end result was a small net drag on our return. At the end of October, we were licking our chops at the bargains we were hoping would keep landing in our lap. Had the year finished any way other than how it did, our short-term cash fluctuations would almost certainly have been a tailwind.

As recently as September 2022, our portfolio's cash balance was just 1.6%. We will have it there again, and likely lower. It all depends on the depth and breadth of ideas we are finding.

Don't confuse our cash management with market timing. We don't need the whole market to become attractive to find ways to make money. There's always something to do, and conditions with even the slightest uncertainty or hesitancy on the part of fixed income investors can mean a buying spree for EdgePoint Portfolios.

Cyclical opportunities

As fixed income investors, we're active in both the new-issue market (buying bonds issued directly by businesses that need to borrow money), and the secondary market where we buy existing bonds sold by other investors. In the new-issue market, businesses will generally issue bonds when they need to, and this pipeline is as robust as ever, as companies that had been dragging their feet on refinancing into this higher-interest-rate world start taking their medicine.

Opportunities in the secondary market are less predictable but equally common. Broadly, there are three ways we've observed high-yield investments to become "mispriced" in the secondary market, where yields overstate the risk we see in the business' future prospects. Two are fairly obvious – first is for a major macroeconomic event to cause broad mispricing across the entire market (e.g., Fed rate hikes in 2018 or initial pandemic lockdown in March 2020). Second are idiosyncratic events that temporarily impact one specific company (e.g., a large acquisition or a poorly performing unit masking an otherwise healthy business).

The third is less obvious but no less fruitful. Recently, it's been fun watching TV commentators try to gauge the economy. For instance, a host will interview some over-indebted San Francisco office landlord on-air, teary-eyed and describing utter economic collapse, only to be followed by an airline executive who's raising prices, never been busier and threatening to sue Boeing for not delivering the billion dollars-worth of aircraft he needs to satisfy record demand.

There's more than one business cycle, and while the trajectory of overall economic activity is generally higher, there are often parts of the economy that feel like a recession. Taylor Swift selling out 50,000 seats at $1,000 a pop doesn't look like a recession, but the guy retailing patio sets who just had two record-smashing years is now in dire straits. Ideas on the periphery of these cycles can make for excellent investments, as shown below.

Examples of EdgePoint's fixed income holdings vs. popular market opinions
2018 to 2023

	2018	2019	2020	2021	2022	2023
Market consensus	*"Retail apocalypse"*	*"Oil is uninvestible"*	*"COVID forever"*	*"Supply-chain nightmare"*	*"The office is dead"*	*"Lockdown beneficiary, but no more lockdown"*
The willingness to look different from the crowd	**Mattel** 6.75%, due 2025 *Toy manufacturer + Toys 'R Us goes broke.* **Internal rate of return** **9.7%**	**Tervita** 7.625%, due 2025 *Oil & gas waste processing company.* **Internal rate of return** **30.0%**	**Cinemark** 5.25%, due 2028 *Second-largest movie theatre chain in the U.S.* **Internal rate of return** **16.5%**	**New Flyer** 5.0%, due 2027 *Public transit bus manufacturer. Record demand but can't get parts.* **Internal rate of return** **3.1%**	**Interface** 5.5%, due 2028 *Commercial flooring manufacturer selling into offices, schools, hospitals.* **Internal rate of return** **20.0%***	**Footwear manufacturer** *Hiking boot and running shoe revenue up >50% from 2020 to 2022.* **Internal rate of return** **9.0%***
All returns are internal rates of return (IRRs) in local currency. Returns less than one year are marked with an asterisk (*) and cumulative.	**L Brands** 6.694%, due 2024 *Owner of Victoria's Secret and Bath & Body Works – 1/3rd stores at mall, and no one's at the mall.* **Internal rate of return** **15.6%**	**Vesta** 10%, due 2025 *Alberta-based, light-oil producer.* **Internal rate of return** **17.5%**	**Lindblad** 6.75%, due 2027 *Expedition cruise-line sailing the Galapagos and Antarctica.* **Internal rate of return** **13.6%**	**Park-Ohio** 5.25%, due 2028 *Fastener distributor whose customers can't get parts.* **Internal rate of return** **12.5%**	**Cushman & Wakefield** 5.25%, due 2028 *Commercial real estate sales and leasing broker.* **Internal rate of return** **19.1%***	**Lawn & garden-care company** *Sales of lawn seed, fertilizer, garden care up +37% during lockdown.* **Internal rate of return** **20.7%***

As at December 31, 2023. All returns are internal rate of return in local currency for the EdgePoint's flagship credit portfolio. Internal rate of return is money-weighted return that accounts for the timing and magnitude of cash flows into an investment and represents an investor's actual return. As at December 31, 2023, the above securities are/were held in EdgePoint's flagship credit portfolio. Additionally, all of these securities may have been held in at least one of EdgePoint Global Growth & Income Portfolio, EdgePoint Canadian Growth & Income Portfolio or EdgePoint Monthly Income Portfolio. Information on the above securities is solely to illustrate the application of the EdgePoint investment approach and not intended as investment advice. They are not representative of the entire portfolio, nor is it a guarantee of future performance. EdgePoint Investment Group Inc. may be buying or selling positions in the above securities. Years reflect the market consensus themes, while our holdings reflect EdgePoint's focus on buying or lending money to businesses irrespective of popular opinion.

In 2018, when retail space was oversupplied given the growth in eCommerce, the demise of Toys 'R Us led to our investment in Mattel. Once we could see the end of COVID-19 and handicap the cost of getting to the other side, we found a movie theatre operator whose bonds were priced for lockdown forever. When business reopened to insatiable demand while Asian manufacturing remained shuttered, we bought the bonds of industrial companies whose supply chains were frozen. And early this year we made investments in companies impacted by declines in office occupancy, but whose unrelated business lines were fine.

Companies that were clear COVID-19 beneficiaries have been our latest hunting ground. At least part of the sales growth from the past few years will have been a pull forward in demand. As the world normalizes, sales for these businesses are overcorrecting and volumes today are often lower than 2019 levels. In the final weeks of the year, the bonds of a footwear manufacturer and a lawn & garden care company that were recently purchased rose with the rest of the market, but we expect related opportunities in the months ahead. These cycles-within-the-cycle will continue.

Resolutions

This temperamental market has been ideal for bond pickers. As lenders, your EdgePoint Portfolios with fixed income holdings continue to ride the tailwind of materially positive interest rates. You'll benefit if they move even higher. It's possible this has been a short-lived bonanza and that rates revert right back to zero – but maybe not. If the financial future is different from the recent past – if higher rates are here to stay – it will benefit lenders at the expense of borrowers and owners of assets. Higher interest rates could mean higher volatility, where bursts of optimism are followed by widespread pessimism. We like mood swings.

After being grumpy all Christmas, we hope to uncover the joy of Boxing Day bargains as we enter the new year.

[i] Source: Seth Klarman, "The Painful Decision to Hold Cash", *Baupost Limited Partnerships' 2004 Year End Letter.*

Published January 16, 2024.