Mr. Innovation and his buddy, Mr. Great Idea

By Tye Bousada, EdgePoint portfolio manager

There are few industries where a long period of innovation has caused the average participant in those industries to be worse off. Civil engineers can agree that a lot of the skyscrapers constructed today wouldn't have been possible 50 years ago and that innovation has benefited the field of engineering. Likewise, heart surgeons can achieve more today than even 10 years ago and their patients are better off for it. Innovation has benefited the field of medicine. Think about your own field of work. My guess is there are many examples of innovation benefiting you and your customers over the last decade. What about investing? We contend that innovation in the field of investments has actually moved the average market participant backwards.

We realize this is a strong claim and in an effort to defend it, let's start with what the stock market was originally designed to be. At its most basic level, the market is where the seller of a piece of a business can meet a buyer, making price discovery easier. Put another way, in a place that brings lots of people together, the seller of a business has a better chance of finding a buyer at a price both sides can agree on.

To demonstrate how far the majority has moved away from this basic purpose of the stock market, let's walk through a hypothetical situation. Imagine you have $500,000 to feed, shelter and clothe your family for the next 30 years. You need to invest this money to protect your family against inflation. Now, imagine Mr. Innovation shows up on your doorstep and says, "I have a business to sell you and the price I put on it is $500,000." You reply, "As it turns out, I have that sum to invest, so tell me about your business." He responds: "All you need to know is that a bunch of PhDs have analyzed the business's historical share-price movements. Based on their super-computer algorithms, they believe its price will be higher in three months' time. So give me your money." Would you do it? My guess is no. Would it surprise you to hear that billions of dollars change hands on the stock market every day based on this approach? It's called the "quant" method of investing.

Imagine that after you decline Mr. Innovation, he tells his buddy, Mr. Great Idea, of your $500,000 to invest. Mr. Great Idea rushes over to sell you his food index fund. You start your line of questioning with, "What does the business do?" Mr. Idea tells you that you aren't actually buying a business. Instead, you're buying a collection of derivative counterparty contracts whose value rises and falls with the price of food commodities ranging from wheat to coffee. Confused, you follow up with, "Why should the price of coffee go up in the future? Is the world short of coffee?" To which Mr. Great Idea answers, "Well, coffee is only one of the commodities in the index fund. If it doesn't go up, others will. Everybody knows that the world is short of food commodities right now so you should buy today." You gently reply with the obvious question: "If everyone knows that the world is short of food commodities, wouldn't its price already reflect this common knowledge?" Mr. Great Idea seems stumped. You feel bad for him and decide to change your line of questioning. "If the price of wheat rises by 50% and the price of coffee falls by 30%, do I end up with more exposure to wheat and less to coffee?" Mr. Great Idea tells you yes, that's how index funds work – you own more of what is expensive and less of what is inexpensive.

At this point, Mr. Great Idea looks flushed. He hasn't yet encountered a potential investor who uses so much common sense. He gives you an awkward smile and leaves. Would you give Mr. Great Idea the money you have to feed, shelter and clothe your family for the next 30 years? I don't think so. While this example might sound ludicrous, billions of dollars change hands every single day on the stock market based on this type of index investing.

What's lost in the mix is that the billions of dollars thrown into quant and other index strategies is for feeding, sheltering and clothing families for the next 30 years. This has become acceptable practice just because it's the stock market. (Please note that we don't mean to pick on quant or index strategies – they're just two examples among hundreds we chose to make our point).

How would you approach investing your family's future in a business? You'd likely start by deciding not to invest hastily. You'd want to follow a business for a long time prior to making an investment. You'd want to see opportunity for the business to grow its revenue and maintain or grow its profit margins over an extended period. You'd want it to have a solid management team with a vision you believed in. You'd want to see its defendable barriers to entry and have it profitably deploy the future capital it generates. Most importantly, you'd want all of these great things without paying full price for the business. If you were engaging your family's future, you'd work hard to find an opportunity to buy into a great business for less than you thought it was worth. You might choose to go to the stock market to find this opportunity, where each day there are millions of business sellers looking for business buyers.

At EdgePoint, we approach a business as if it was going to feed, shelter and clothe our families for the next 30 years. This is easy to say at EdgePoint, because the 29 partners who work here are collectively the single-largest investor in our portfolios. The approximately 35 businesses (equity holdings) that make up the Portfolio are literally charged with taking care of our loved ones.

At EdgePoint, we're long-term investors in businesses. We view a stock as an ownership interest in a business and endeavour to acquire these ownership stakes at prices below our assessment of their true worth.

We believe the best way to buy a business at an attractive price is to have an idea about it that isn't 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 with strong competitive positions, defendable barriers to entry and long-term growth prospects that are run by competent management teams. Our portfolio holdings generally reflect our views looking out more than three years. We firmly believe that focusing on longer time periods helps us to develop proprietary views not reflected in current stock prices.

Our approach is deceptively simple. We buy good, undervalued businesses and hold them until the market fully recognizes their potential. This approach requires an ability to think independently, a natural curiosity necessary to search out new ideas and a commitment to embrace the thorough research required to uncover opportunities the market doesn't fully appreciate.

Let me take you back to the example where you have a fixed sum to invest to protect your family for the next 30 years. Imagine that the owner of Harman Intl. Industries showed up on your doorstep in November, 2008 and asked you to buy his business. You know Harman well having followed and admired the business for years. You know it's the world's largest provider of car sound and infotainment systems (infotainment systems are the computers and LCD screens in cars through which you access and control everything from the radio to the air conditioning). You know that Harman owns some of the world's most well-recognized audio brands including Harman/Kardon, Infinity, JBL, Mark Levinson, Lexicon and AKG. You're also aware of the huge growth opportunity for infotainment systems. Today, only high-end cars have these systems. But in the future, all cars likely will, which means the market can potentially grow by over 500%. As the largest provider of infotainment systems, Harman stands to benefit from this growth. Over the last seven years, they've grown their revenue by 239% and their profits by 250%. Harman's management team has demonstrated sound business judgment in the past and you believe they're the right team to lead Harman in the future.

Now, the owner of the business (not to be confused with the management team) is a little depressed. He thinks that because we're in the middle of a big recession (remember, this is November, 2008), no one is ever going to buy a car again and that the near-term prospects for his business are poor. You, on the other hand, don't care about the business's short-term prospects. You believe the recession will end eventually and when it does, Harman will return to rapid profitable growth. Because the owner is depressed, you believe he'll accept 3X normalized earnings for his stake. So, when the business returns to a normal state, you'll make 33% annually on your investment before accounting for growth (33% = 1 ÷ 3). Do you invest? We did. We were willing to engage our family's future in Harman and acquired shares for around US$15 each in November, 2008 and as low as US$10 a few months later. We bought those shares on the stock market from owners who were terribly emotional. During the last two-and-a-half years, the world didn't stop buying cars and Harman has continued to grow. The company's share price appreciated to the mid-$40 range and in May we finished selling our stake.

In summary, we attempt to approach investing in these turbulent markets with a sense of measured confidence. We'll continue to view the stock market as a place where buyers and sellers of businesses can meet and won't get caught up in the innovations of the day. Finally, we'll constantly adhere to our time-tested investment approach.

We thank you for your confidence in us and look forward to the opportunity to build wealth for you over the long term.

Sincerely,

Tye

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

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