4th Quarter, 2010 Commentary
EdgePoint Canadian Portfolio

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While this commentary may focus on the most recent year, we don't get too excited about relative results over such a short period of time. Our objective is to exceed the performance of major stock market indices over the long term, and not on an annual basis. This is not an excuse to hide from relative underperformance. In fact, we've done relatively well over the past year and since inception.

Don't Fear the Opportunity, Again

I thought I'd begin this year's commentary by reviewing how we ended last year's commentary. In fact, this will be our third year-end commentary where we've asked our investment partners not to fear the opportunity that the market pessimism is providing. We wrote about investor pessimism and how it resulted in an unwillingness to pay for growth potential. This provided investors with the opportunity to buy companies whose future growth prospects were not reflected in their stock prices. We suggested that buying a business from a seller who had worries about the future and ignored the growth potential of a business was a very good way of making money.

Are Fractures Developing in the Logjam of Pessimism?

It's hard to believe that for a third year in a row, and with the portfolio up approximately 80% since its inception only two years ago, we'd still be talking about the opportunity to take advantage of the entrenched pessimism in the market place.

While the pessimism is obviously less evident today (or else our stocks wouldn't have increased), and in fewer pockets of the stock market, it still has strong roots. Look no further than the record flows into bond funds and into faddish "get paid as you wait dividend income solutions to all your problems" yield funds. The majority of market participants have decided to turn conservative after losing money!

Though there are a few cracks in the logjam of pessimism, pessimism still looms large in certain pockets of the Canadian marketplace. The average investor's desire for certainty is providing dislocations in the marketplace that we can take advantage of.

Perceived Risk Versus Real Risk

The predictable move to conservative investments, which typically happens following a crisis, has happened once again causing a dislocation between perceived risk and real risk. This always happens at market extremes (market highs and market lows). There are many examples of this.

Nifty Fifty's: Think back to the early 70's when the perceived risk of buying Nifty Fifty stocks was very low. These companies were all great businesses and everyone was buying them. These stocks then proceeded to lose half of their value. Though the perceived risk was low, what was the real risk?

Oil**:** There was little perceived risk in buying oil stocks in the 1979 - 1980 time period. After all, experts said that there was only 10 years of oil reserves left. Once again, you would have lost half your money in relatively short order. There was substantial risk in an area of the market that had little perceived risk.

Japan: There was certainly no perceived risk in owning Japanese equities in 1986. Investors were reading books about how smart the Japanese were in an attempt to emulate their successes. Where was the risk in a country that had things figured out?

Technology: Few investors would disagree that there was little perceived risk owning technology and internet stocks in 1999 to 2000. Their growth was a certainty...

Time and time again, history has proven that when perceived risk is low, prospective returns are low and often negative. Prices of securities are bid up to a level that reflects their perceived certainty, and then some.

We would suggest that in each situation where little perceived risk exists, significant real risk is lurking around the corner. It is likely obvious to the readers of our commentaries why this phenomenon re-occurs. It doesn't even have to be explained, but it certainly should be taken advantage of.

Investors Turning Conservative ... and Take on Real Risk in the Process

Where is the perceived risk low today? Stated another way, "where is the real risk high today"?

Investors are disappointed with stocks today. The 2000's have not been kind to the average equity investor and investors are extrapolating the poor performance of the past decade into the next decade. As we've said many times, it's the entry price of an investment that dictates your returns. What was the entry price 10 years ago? For the average investor who sought certainty in technology stocks believing in the growth of the internet, the entry price was wrong. While there may have been nothing wrong with many of these businesses, there was something wrong with the entry price.

Many investors consider equities today to be a high-risk, low-return asset class because they are extrapolating the past decade's experience. Because investors are worried about the future or because they have been burned by their past investment experiences, investors have flocked to the warm and fuzzy feeling of certainty – a place where perceived risk is the lowest.

In the fixed-income market, the flock to certainty is reflected in very low government bond yields. There is risk that many governments will not be able to pay you back; other governments will likely pay you back with a depreciated currency, while other lucky investors will recoup their original principal. The balance sheets of many governments paying 1% to 3% look just as weak as those that are paying out 5% to 8%. Certainly the perceived risk must be low if investors are settling for such low returns. We wish investors luck in deciding which low risk bonds they should purchase. We'd also like to remind investors that even if they get their principal back, their investment may not feel like much of a success if inflation turns out to be normal.

The perceived risk is obviously very low and it seems obvious that the prospective returns will also be very low (to be generous).

The flock to certainty can also be seen today in the unquenchable desire to own slow growth companies, zero growth companies, or companies in structural decline ... as long as they pay a dividend. This investment approach will only win if stocks never appreciate in value again. Since common thought is that stocks are unlikely to go up because they haven't gone up in the past decade, investors have decided that they should get paid while they own a security. Once again, investors are extrapolating the experience of

the past decade, rather than asking about the entry prices of the various potential investments they could buy.

Let's look at an example:

There are two major pipeline companies in Canada today (TransCanada Corp. and Enbridge Inc.). Both companies are regulated utilities, offering some certainty for investors who are worried about the future. It's fair to say that pipeline companies are low-growth companies. The average price-to-earnings multiple of these two companies, using 2010 earnings, was approximately 20x - an earnings multiple generally reserved for growth stocks. The reason for this is because if you pay 20x earnings for a slow growth business, your returns will likely be low-to-negative.

Pipeline companies are loved today because they offer the certainty of a regulated business combined with a dividend yield. The average dividend yield of TransCanada and Enbridge is approximately 3.5%. Since stocks could stay flat over the next decade as they did in the last decade, pipeline companies allow investors to "get paid while they wait". The income-yielding funds that are so popular right now are all loaded with these types of securities.

Let's think about the logic of this for a minute.

- Investors feel burned by the stock market
- Investors question why they should own stocks given their flat performance over the past 10 years
- Investor fears are elevated by all of the uncertainties they read about every day. This compounds their uncertainties towards stocks.
- Few investors understand that the problem was the prices they paid 10 years ago. This leaves investors susceptible to another investment mantra that ignores price.
- "Investment companies" convince investors to buy "income" funds. A new mantra ignoring price is born.
- With so many uncertainties, "getting paid while you wait" is a genius concept. Investors wonder why this investment approach wasn't invented 100 years ago.
- If stocks go nowhere for the next decade, investors will still "get paid"
- Companies, such as pipeline stocks, with a whopping 3.5% dividend yield are purchased in income-oriented mutual funds. Given the typical fat MERs in the mutual fund industry, let's be generous and assume there will be 1% per year left for the investor (3.5% yield minus 2.5% MER), before tax of course.
- Investors believe there is little perceived risk in stocks that pay a dividend. This results in dismal prospective returns.
- If stocks do go up again (i.e. as they have in the last two years), how much money can be made owning pipeline companies at 20x earnings?

While this premium valuation associated with slower growing companies is something that is happening worldwide, it is certainly pronounced in the Canadian market. We think it's a phenomena best observed from the sidelines.

The Canadian Stock Market – A One Trick Pony?

One of the arts of portfolio management is the construction of a portfolio. It's much easier to be a good stock picker than it is to be a good portfolio manager. There are many things that must be taken into consideration when building a portfolio that "makes sense". One of the most important things is to ensure that the portfolio is a collection of different investment ideas. The death of any portfolio is investing in a collection of securities that represent only one idea. These types of portfolios and portfolio managers come and go, but they rarely stand the test of time. Sustainability, proper balance, appropriate diversification and appropriate risk-adjusted returns come from owning a collection of different business ideas with no one idea dramatically correlated to any other idea in the portfolio. This is easier said than done, and much easier said than done when investing in the Canadian stock market today.

Not only is the Canadian stock market small, representing only 3% to 4% of the world's market capitalization, it is also highly concentrated in a few industries. For example, over half of the S&P/TSX Composite index, Canada's benchmark stock index, is comprised of resource and resource-related companies. As such, the average Canadian who invests in Canadian equities likely has 50% of his or her investments in resource-related stocks. If that investor's allocation to Canadian equities is only 3% to 4% of his or her net worth (i.e. Canada's representative weight within the global market), then this would really be a non-issue.

But, because Canadian equities have performed much better than global equities over the past decade, the average Canadian investor undoubtedly assumes the next decade will be very similar. As a result, the vast majority of his or her investible net worth is likely invested in Canadian equities. This unfortunately means roughly half his or her investible net worth in resource-related stocks.

Does this make good financial sense? If these types of stocks continue to go up, then I suppose the answer could be yes. But, as I mentioned earlier, a proper portfolio comes from owning a collection of different ideas. I would argue that resource stocks generally represent one broad idea and that one broad idea is strongly correlated to a country on the other side of the world that few Canadians have ever visited. In other words, problems in that one country (a slowdown in its growth for example) could have negative consequences on all resource stocks.

Investors may think they are diversified because they own 40 Canadian stocks or a basket of six or seven Canadian mutual funds. But if these stocks or mutual funds look like the typical Canadian portfolio, then 50% of these "diversified" portfolios are invested in one idea. Does it matter how strong that one idea is? Is any idea strong enough for 50% of one's net worth? What are the consequences should that one idea not work out as planned?

Just because 50% of our index is represented by resource stocks, it doesn't make it right. Was it right when over 50% of our index was invested in technology, media and telecom (TMT) in 2000? The Canadian index is rarely a fair representation of the actual investible ideas in a marketplace. TMT was **one** idea in 2000, even though it represented 50% of our index and a collection of different securities. Today, resources represent one idea and unfortunately make up approximately 50% of our index.

Being a bull on resources means you have to be a bull on China. Would a bear on China have to elaborate on the bubble in China and talk about how home prices are 22x disposable income in Beijing? Or how the

International Monetary Fund said that land sales make up 30% of Beijing's local government revenues, or how Fitch Inc., an international bond rating agency, recently highlighted that private credit in China is now 148% of GDP? Should you have to remind all the China bulls out there how a one-child policy is a sure-fire way of cutting your population in half (you'll be reading more about this problem in the coming decade)?

The reality is that none of this really matters. Even if you were a believer and you didn't think China is experiencing a bubble of epic proportions, should you have 50% of your net worth on a one-way bet that the next decade for China will be like the last decade? Prudence would suggest that even the biggest bull would say "no". Then why is the average investor in Canada so exposed?

We're content with EdgePoint Canadian Portfolio's investment results over its first two years. Not simply because they have set us in the right direction towards our long-term goals, but because we've achieved these results through a collection of different ideas and not simply by being exposed to some of the hot areas of the market.

Sincerely,

Geoff

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