Written by Geoff MacDonald

One of the most common questions we get about our investment approach is regarding our "sell discipline". Though we have a small paragraph on our website entitled "When do we sell a business", it often gets far less attention than other aspects of our investment approach. It's simply more exciting to talk about the wonderful prospects of the businesses we own than those we no longer own.

This isn't surprising. I was in a bookstore in Belleville this weekend (long story) perusing through the business and investing section and I didn't see any books on how to sell stocks, or books about investors that were great sellers, or biographies of business tycoons entitled "He got there because he sold his shares".

The truth is the selling price of a stock can be just as important to long-term investment returns as the initial purchase price. One of my favourite quotes highlighting this point is from J.P. Morgan. When Mr. Morgan was asked how he got so rich, he replied "*I made a fortune getting out too soon*".

Below is the paragraph from our website that we use to explain how we sell a business. I'd like to provide more colour to this paragraph and finish with an example of a company we recently sold.

> We generally sell a security for one of two reasons. First, our thesis about the business is deemed to be no longer valid. If we can no longer stand behind our thesis on the business, we can no longer stand behind an ownership interest in it, and the position is sold. Second, there is a constant culling process whereby we continuously strive to upgrade the quality of the portfolio with better ideas. For example, if one of our ideas becomes well recognized and this is reflected in the share price of the investment, it is removed in favour of a more attractive opportunity.

We believe the best way to buy a business at an attractive price is to have an idea about it that is not widely shared by others, what we refer to as a proprietary idea. We believe the collective judgement of the market is reflected in a company's stock price. If you have reason to believe that this judgement is wrong, then you have a proprietary idea. Although I promised to discuss our sell approach and not our buy approach, the truth is, you can't sell businesses successfully over time if you don't know why you purchased them in the first place. If you don't believe me, think back to the last time you bought a stock based on a tip from a friend and the helpless feeling you had as the stock dropped. Knowing why you bought the business in the first place is the first thing required to sell a business successfully.

Furthermore, our investments reflect our view of a company's prospects looking out more than three years. Focusing on longer periods of time enables us to develop views that are generally not reflected in the current stock price. This opportunity most often exists when market participants are focused on the short term, not the next three years.

This is the approach we take with every investment (from the time of purchase and throughout the entire holding period). We ask ourselves the question, "What do I know about the business that others don't see?" If the answer is nothing, then there is no advantage and no investment is made. Only invest when you have

an advantage. Each investment we've made was because we believed we had an edge. Overtime, this idea (the "edge") can change and evolve.

Remember, an idea can take many forms. It could be market share gains from weaker competitors, expansion into new markets, new products coming down the pipeline, new management turning around the company, etc. It doesn't matter what the idea is as long as it can be material to the value of the company and it is not reflected in the current stock price.

We simply sell our investment when the idea has changed. Hopefully, the idea has changed because the stock has gone up materially in price reflecting the opportunity we identified two years prior, and the stock market is now excited about the company's future prospects. If your view of the company's prospects is the same as everyone else's, then from an investment perspective you know nothing. Your edge is gone, so why hang on? These are the great sales opportunities because chances are you've made a very attractive return.

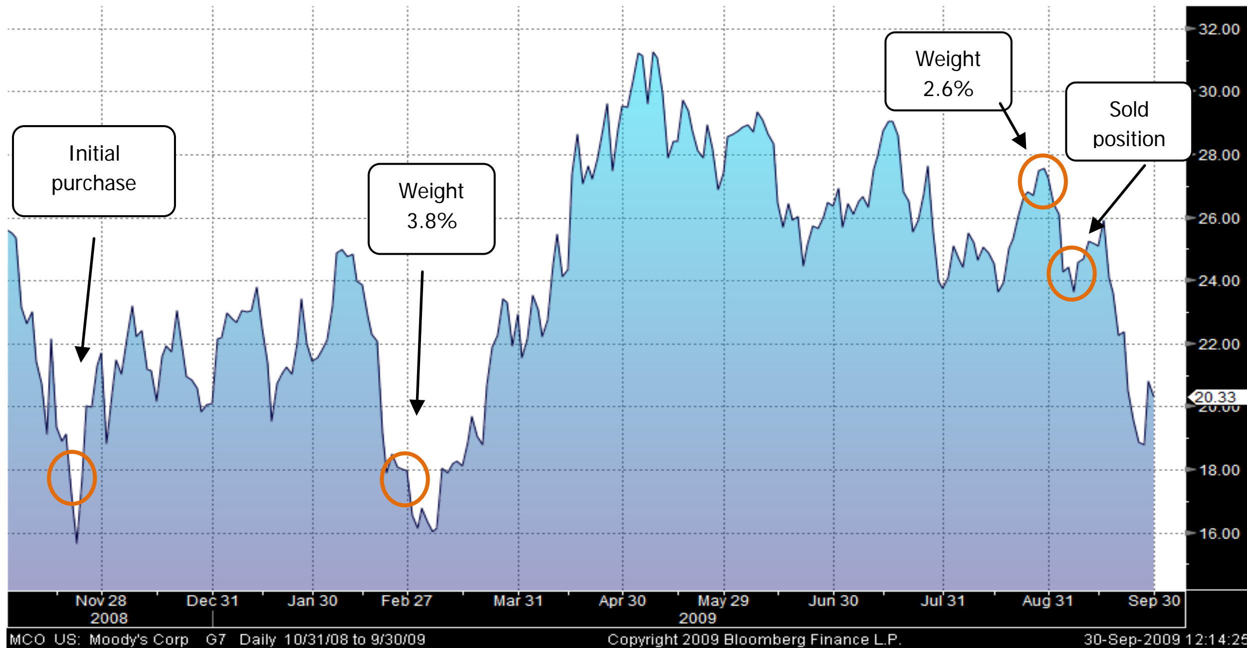
There are many other reasons why your idea on an investment can change. Maybe the company made an acquisition that not only changes its focus, but dilutes your idea. Perhaps the opportunity to steal market share from competitors lasts for a couple years, but then competitors catch up with a more competitive product. Maybe you realize that the turnaround opportunity with the new management team will be much tougher than you originally expected. As Warren Buffet has often said, sometimes the best jockey in the world can't help you win the race if you're on the wrong horse. We believe it would be silly to continue to hold onto a stock should any of these things occur just because the stock "was purchased at a cheap price" or "still looks cheap" or "has fallen so much that it's not a good time to sell" or "will probably go higher later". If there are no longer any enduring material qualities about the business that aren't already reflected in the stock price, then there is no idea and no advantage. Again, why invest without an edge?

Sale of Moody's Corp.

Interestingly enough, I profiled the investable idea behind Moody's in the first quarter 2009 commentary. I won't reprint the note here, but below were the five main points behind our investment thesis:

1) The credit crisis will eventually subside
2) Moody's dominant role and business model will emerge predominately intact
3) Corporations will increasingly turn to the public markets for debt financing as banks will be regulated to hold more capital
4) European and Asian markets will grow substantially because their public debt markets are much less penetrated than the U.S. market
5) The above four points were not reflected into the stock price at the time of purchase as it was trading at approximately 10x earnings

Point 1 happened pretty quickly and was happening at the time of the commentary, which we highlighted. This alleviation of the credit crisis alone caused the stock to rise materially within the span of only a couple months. The chart below highlights the dramatic price rise in Moody's shares between March and May of this year.



The main investment risks identified at the time of purchase were as follows:

1) Rating agencies would be much more regulated in the future
   - We agreed with this "risk". We assumed that increased regulation could cost Moody's approximately 1000 basis points to their operation margin, but would still be an incredibly attractive business
2) New competitors, untarnished by the credit crisis, would enter the ratings business
   - This is not something we worried about. The huge sums of capital and time required to enter this business and compete with the already well-established brands sounded like a suspect business case to us
3) It's a new era and credit issuance will never approach previous levels
   - This is another risk that we gave little credibility to
4) The business model will change. Rather than getting paid by the issuers, rating agencies will have to charge a fee for their ratings in order to generate revenue
   - The thought of the Obama administration restricting formerly free information to the general public by only allowing it to reach the hands of those rich enough to afford it seems opposite to this administration's directions...to say the least.
5) Moody's loses lawsuits over poor ratings
   - It was well known that rating agencies were facing legal threats linked to their role in the boom and bust in structured finance, where banks pooled everything from home loans to kitchen sinks into bonds that were sold to investors. Institutional investors taking Moody's to court would have to admit they didn't do their homework, didn't know what they were buying, relied solely on ratings from a company that had been as accurate as the weatherman, and had no concept of their fiduciary duty. Though it sounds improbable that investment management institutions full of MBA's and CFA's

would admit to such ignorance to their fiduciary duties, firms were lining up to do so. At the very least, it would provide much entertainment to the readers of the Wall Street Journal and nightmares to the respective institutions' clients.

Regardless of our opinion whether they would be sued, this is not what we worried about.

What gave us great comfort was the fact that rating agencies have always been protected under the First Amendment (freedom of speech). Just as the weatherman can give his opinion on the chance of rain or an economist can provide his opinion on the future of the markets, Moody's has been able to provide its opinions (ratings) on credit without being sued.

Now, if the weatherman was constantly calling for rain in order to profit from people rushing out to buy umbrellas from his brother-in-law's shop, then you may have a case. But if he did his proper investigation and incorrectly predicted rain in the forecast, while you can be angry, or demand he gets fired for incompetence, or simply choose not to listen to him next time, you can't sue him for being wrong or incompetent. He is protected by the First Amendment. He'll make mistakes but will hopefully learn from them and tweak his probability analysis or tweak how he looks at the satellite imagery the next time. Similarly, the rating agencies admit they missed the housing collapse (as did Congress & the Securities and Exchange Commission (SEC) who are now desperately looking to blame anyone else but themselves) but have said changes in their business model and additional regulation will help avoid such mistakes in the future. Because Congress & the SEC make the rules, they'll be successful blaming everyone but themselves. But that was the first risk we mentioned on Moody's and we more than factored it into our analysis.

Similar to the weatherman, Moody's has been protected under the First Amendment since its inception and has been their primary line of defence.

On September 3rd 2009, however, the public learned of an order issued by a U.S. judge in Manhattan stating that ratings on notes sold privately to a "select" group of investors were not "matters of public concern" and therefore not deserving of the traditional broad protection under the First Amendment. This decision was the first to specifically address the issue of "specific ratings". There will now be many others arguing for the same treatment. There were billions upon billions of dollars of other structured notes rated for "select groups of investors" which resulted in billions of dollars of losses for these knowingly unknowing investors who bought them.

This potentially changes the ball game, but we don't know how many innings are in the game, nor do we know the rules. We don't even know who all the players are yet, as many more institutions will gladly line up to sue the rating agencies, and admit they didn't know what they were buying! Despite reading the judge's 65-page ruling, we have no more clarity on the situation.

This is a perfect example of a change in the investment thesis. One of the key risks that we identified has now changed. We can no longer feel confident that rating agencies can hide behind the First Amendment. What we can say with confidence is that Moody's doesn't have the capital to fund future claims should they lose a case.

Does Moody's become like the tobacco industry with all of its legal claims or do they win these cases and everything simply goes back to normal? Should we hang on to Moody's with this new uncertainty because we originally thought the long-term value of the business was $50 per share? Or can we find another business with a similar upside return potential without the chance of it going to zero?

Perhaps in a different market we could justify holding onto Moody's, i.e. a market that didn't offer a lot of great investment possibilities. However we're not having any trouble finding great companies that are trading at half of what we think they could be worth, but without the same risks as Moody's. We acted swiftly and sold half of our position on September 3rd and the remaining position on September 4th.

Though the investment was disappointing because it didn't work out as initially expected, Moody's was still one of the largest contributors to investment performance of your portfolio this year and since inception. Looking at the chart on the previous page, you can see it was 3.8% of the portfolio at the end of February (at $17.95/share) yet only 2.6% of the portfolio at the end of August when it was at $26.42/share. The stock was up 47%, yet the weight in the stock went down 32%! This highlights that we took substantial profits in Moody's even before this ruling. The chart highlights where the remaining shares were sold, all at a substantial profit for our investors.

Fixed Income Comments

The rally in corporate bonds continued in the third quarter of 2009, benefitting the Portfolio as Canadian corporate bonds tightened another 50 basis points (.50%) during the quarter, on top of the significant tightening that already occurred in the first half of 2009. Our U.S. fixed income holdings also profited as both investment grade and high yield spreads contracted back to levels not seen since the "Pre-Lehman" era of early 2008.

We continue to invest all of the Portfolio's fixed-income assets in corporate bonds. While the year-to-date tightening has made it harder to find attractive fixed-income investments, we continue to uncover opportunities and exercise patience when we do not see value.

More on Freedom of Speech

Many of you are aware that the McGuinty government is proposing to harmonize Ontario's provincial sales tax with the federal goods and services tax. The decision to jam an additional 8% tax on the management expense ratios of your investment products is shockingly unwise and dangerous. It will result in less money for your retirement years. Unbeknownst to you, this may result in fewer vacations, a missed chance to buy a cottage, or less money for your children or charities. While the negative impact is less severe for mutual fund companies, we feel it's terrible for the long-term investor. We urge you to read our comments on this proposal (available on our website) which illustrates how this could cost you up to 100% or even 350% of your initial investment over time.

We've recently heard that the McGuinty government is now in talks with the mutual fund industry and is considering an exemption to the harmonized sales tax. While we're extremely pleased with this news, we believe it's important for individuals to continue to express their concerns with this proposal. We urge

residents of Ontario to contact your Member of the Legislative Assembly (MLA) and hope that people will act quickly. Contact information can be found in our comment letter.

Sincerely,

Geoff MacDonald

Investment Results: In accordance with the Canadian Securities Administrators' National Instrument 81-102, we are not permitted to discuss investment results until the Portfolio is one-year old. This information, however, is readily available from publically-accessible websites and newspapers.

Note to readers: We will endeavour to share with you what we would want to hear if our positions were reversed. In an effort to improve our communication with you, Tye Bousada and I alternate writing the commentary, giving you a chance to hear from each of us twice a year. While we adhere to the same investment approach, our styles of communication are different. Our hope is that you gain a solid understanding of how your money is being invested.

Commentary as at September 30, 2009. The above companies are selected for illustrative purposes and are not intended to provide investment advice. EdgePoint Investment Management Inc. may be buying or selling positions in the above securities.