The right choice for our families

By Tye Bousada, portfolio manager

You're saving for something important. Perhaps it's retirement, your children's education or to be able to check off an item from your bucket list. Whatever the reason, you've decided to allocate to EdgePoint a portion of those savings in the hopes that we can grow it for you over a realistic timeframe. Our goal is to deliver performance for you that's at or near the top of our peer group over ten years. Having opened our doors just over three years ago, we're approximately a third of the way toward achieving our first ten-year milestone. Thus far, our absolute and relative performance, while pleasing, is in the past. The only thing that matters now is the future. How are we going to grow your wealth from this point forward?

Traditionally, an annual commentary would assert that the future is bright and that you should rest easy knowing your money is in good hands. Instead of following convention, I thought I'd change the frame of reference. Here's what I mean.

Our employees – 28 partners in total – are collectively our largest investor (at last check, together we had some $24 million in EdgePoint investments). For many of us, me included, our personal stake in this company represents the lion's share of our investable assets. Stated another way, most of the money earmarked for taking care of our families for decades to come is with EdgePoint. So, instead of telling you why you should entrust us with your hard-earned savings, I decided to use this commentary to communicate why we've seen fit to entrust our families' future with EdgePoint.

Our investment approach and inefficient markets

We're long-term investors in businesses. We view a stock as an ownership interest in a high-quality business and endeavour to acquire these ownership stakes at prices below our assessment of their true worth. We believe that 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 that have strong competitive positions, defendable barriers to entry and long-term growth prospects that are run by competent management teams. These holdings generally reflect our views looking out more than five years. We firmly believe that focusing on longer periods enables 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. Following 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.

To be successful, our investment approach also requires inefficient markets. Fortunately, for as long as we've been investing, pockets of market inefficiency have existed. What's an inefficient market? It's one in which businesses are misunderstood and mistakes are made, causing stock prices to deviate from their true worth and allowing us to come up with proprietary insights about individual businesses.

These mistakes result from situations including, but not limited to: not doing your homework, disregard, incomprehension, unfamiliarity and, most common of all, letting emotion creep into investment decisions.

The financial impact of emotional investing can be devastating as it causes investors to behave irrationally. The good news is irrationality creates opportunities for those who can resist it. It's our job to live in a narrow emotional band and seize opportunities presented to us by irrational investors. Since our inception in 2008, we've only known markets fraught with fear and emotion. 2011 was no exception. Investor sentiment took market volatility to near 50-year highs, allowing us to position our portfolios to deliver superior long-term performance under a wide variety of outcomes. This is the main reason we're comfortable tying our families' future to EdgePoint.

Let's look at 2011 in more detail.

MACROmatosis

Yes, we invented this word and here's how we define it:

MA•CRO•ma•to•sis (*noun) A diseased state of mind caused by a barrage of macroeconomic news, such as sovereign debt risk in Europe, high unemployment levels in the United States, spiking household debt in developed markets and slowing global economic growth. Those investors infected with MACROmatosis tend to focus too much on the constant stream of bad news and too little on the underlying fundamentals of the individual businesses in their portfolios. In fact, most MACROmatosis sufferers don't even know the value of what they own and are therefore incapable of acting rationally if, and when, the price of their asset changes. The end result of MACROmatosis is emotional investing, which drives people to make investment decisions that materially impact their future wealth.*

In the stock market, a business's price is set by the most-panicked seller. However, the business's value is created by its assets and future cash flows. The issue is most market participants don't have a good understanding of what they own. When the price of a stock goes down, these investors act on emotion because they lack knowledge about the underlying business. Let's walk through an example of what I'm talking about.

Say 100 people are asked to price a new Ford F150 pickup truck. Most would value the truck somewhere between $25,000 and $45,000, and they'd be correct in their assessment. Now, say those 100 people are offered the truck for $200. Surely, all 100 will accept the offer and no one will lose sleep thinking they overpaid for it.

Likewise, the same group could be shown a banana and told interested buyers were willing to pay $100,000 for it. Unquestionably, those 100 people would rush to sell as many bananas as they could for $100,000 each. Not one would lose sleep thinking they sold bananas for too little.

Imagine the same 100 people were asked whether WellPoint, a top holding in your EdgePoint portfolio, was $50, $100 or $300 a share. No doubt very few would have a clue about WellPoint's worth. What if WellPoint's share price fell because of negative macroeconomic headlines, none of which impacted the company's underlying value? How would the average investor react to that price drop? My guess is there would be a rush to sell WellPoint shares. There's almost nothing as uncomfortable as watching the price of something you own plummet when you don't know its value. If someone offered to sell you a second F150 pickup for $180 the day after you bought the first one from them for $200, you'd gladly buy it because you know its value is much higher. How different from the reaction to WellPoint price fluctuations.

We contend that market participants often don't understand the value of what they own and are therefore susceptible to catching a case of MACROmatosis. It's our job to know WellPoint's worth so that we can take advantage of those who don't. During 2011, WellPoint's share price increased 41% to $82, then fell by 30% and rose again by 23% before falling by 6%. It was up 16.5% by year end. You benefitted from this price increase as an EdgePoint Global Portfolio investor. Also, by taking advantage of MACROmatosis sufferers, we added to the position at prices below where the company finished the year.

The flurry of negative macroeconomic headlines hasn't ended with 2011. Of the few guarantees in investing, one is that volatile markets will persist and, if history is a guide, will continue to make people do silly things. History has also shown that our investment approach is best suited to periods of volatility and uncertainty. Therein lies the second reason we've committed our families' futures to EdgePoint.

Reports of capitalism's death are greatly exaggerated

Capitalism is alive and well, and your EdgePoint investment is proof of it. The bigger message is that capitalism is demonstrating the importance of buying growth for free.

Since EdgePoint's inception, we've warned that things will be slower for longer. Such world problems as Europe's sovereign debt issues are real and can hamper growth. That's why we've repeatedly emphasized the need to find businesses that can grow in the face of economic difficulties and not pay for that growth.

The enormity of global economic headwinds has led some people to conclude that capitalism is dead. As always, we believe capitalism is going strong. Consider the takeover offers and share buybacks within EdgePoint Global.

During 2011, five of its businesses were subject to takeovers. By the end of the year, four of the five takeovers (Hughes Communication Inc., Tognum AG, Kinetic Concepts Inc. and Nalco Co.) were complete, representing about 14% of the Portfolio at an average premium of 99% above our cost. The outstanding takeover is for SemGroup Corp., an energy-related company that represented approximately 4% of the Portfolio at year end.

Assuming an accepted definition of capitalism is "the pursuit of profit or return on investment," the completed takeovers are evidence of capitalism at work. In all four cases, we bought businesses we believed were going to be much larger in the future in spite of a tough economy. Over time, others saw the potential we did and decided to pay for it. They offered premiums to own businesses that had high probabilities of delivering healthy growth in a slow-growth world.

Share buybacks provide further evidence of capitalism that you benefited from as an EdgePoint investor. Over 75% of the companies in your portfolio bought back shares in 2011. Share buybacks aren't always sensible; however, in the case of these businesses, we believe they made tremendous sense. It comes down to the price paid for the shares. Following is a simple example.

Say you own a good business with a partner. You've both invested $50,000 in the business for a total of $100,000. Every year, this business generates an 11% return, or $11,000 in profit. If you leave this profit in the company bank account, it earns you another 1% annually.

Down the road, your partner elects to sell you some of his shares. You explain that you'll simply take cash from the company chequing account (earning 1% a year) to buy his shares (that earn 11% annually). Your profit on this transaction would be 10%, or the 11% return on his shares *less* the opportunity cost of leaving the money in the bank to earn 1%. Even after making this clear to your partner, he still wants to do the deal.

Would you? Likely yes. Don't forget, over three-quarters of the businesses you own in EdgePoint Global bought back shares in 2011. All else equal, your partners in these businesses sold you shares that should generate healthy future returns. Not to mention, you should relate to that 11% return in this example because that's the approximate average free cash flow yield of your portfolio's top 10 names (at the end of November 2011). This is the first-year return you can expect to receive as business owner before accounting for growth.

Imagine that after you buy your partner's shares, you manage to double your profits. Under this scenario, your return on the purchased shares jumps dramatically. Not only are the majority of the companies in EdgePoint Global buying back shares, but we believe they can be much bigger in five years, even if the economy is lousy for a lot longer. Who knows why your partners are selling you shares. They're doing it and this should make you wealthier in the future. Share buybacks at the right price can be very profitable for the remaining shareholders, especially if the company continues to grow. Here's another reason we're happy to have our families invested in EdgePoint.

Alternatives

You and other EdgePoint investors own a company called Merit Medical Systems. We started buying the company in early 2011 and its share price continued to fall throughout the year. We built the position up to be approximately 3% of EdgePoint Global.

Merit is a worldwide developer and manufacturer of medical devices used in a vast array of interventional and diagnostic procedures. Its products are used in such fields as cardiology, radiology, gastroenterology, pulmonology and vascular surgery. If you or someone you know has ever had a stent implanted with an inflation device, there's a good chance Merit manufactured that device.

A secret to Merit's success lies in its ability to identify tiny product categories that require innovation and are dominated by competitive giants like Pfizer, Johnson & Johnson and Boston Scientific. A seemingly dangerous strategy, it's proven very profitable for Merit as these small markets have been neglected by the giants. With $65 billion in revenue, Johnson & Johnson doesn't care about a $50 million market. To grow 10% a year, Johnson & Johnson must find $6.5 billion in new revenue. Focusing on smaller categories won't help them to achieve this goal. As such, the giants stop innovating in these areas, giving Merit a chance to enter them. A $50 million category means a lot to Merit as its total corporate revenue is only $360 million.

Merit fits the mould of a business that can grow in the face of a tough economy. Since 2007, the year before the financial crisis started, Merit has compounded its profits at approximately 11% annually. This compares to GDP growth in Canada of about 1.4% a year over the same period.

Merit is entering a number of new markets and geographies in the next five years that could see its profitability expand even more rapidly.

The company is trading for an approximately 7% free cash flow yield. That means if we owned 100% of this business, our first-year return would be 7% before growth. Assuming Merit can continue to grow at the same rate, or better, our annual returns could be above 15%.

How does this compare to our families' investment alternatives? Well, if our families wanted to hold cash, they'd earn less than 1% in a world where inflation is closer to 3% – a recipe for going broke slowly. If they wanted to lend money to the government, they could buy their 10-year bonds and earn 2% annually. They'd still go broke slowly, just a little less so. Our families could buy an index fund. But if the global economy is as harsh for the next five years as it's been for the last four, it's quite possible that markets will be flat for the foreseeable future. (After all, the vast majority of businesses on the stock market need the economy to do well in order for them to do well. If the economy is poor, they'll perform poorly). Better to look for a business like Merit that will likely be much bigger in the future and not pay for that growth today. No wonder the fourth reason we've invested our families' future in EdgePoint is that the alternatives for long-term capital growth aren't nearly as attractive in our minds.

Ted.

Prior to 2011, your Investment team was comprised of Geoff and me as co-portfolio managers and our analyst, Frank Mullen. In mid-2011, we were very fortunate to have Ted Chisholm join us. Geoff and I worked with Ted earlier in our careers and knew he shared our investment approach. We admired his investment capabilities and just plain liked him. This is confirmed by the fact that whenever he spoke about an investment idea, we'd stop what we were doing to listen attentively. Ted's job is to contribute investment ideas.

He's already contributed three to EdgePoint Global, one from Japan, another from Europe and a third from the U.S. – SemGroup. Most investors looked at SemGroup as a company recently emerged from bankruptcy that was guarded in its disclosure on conference calls and had no sell-side coverage. Ted saw a pipeline/mid-stream energy company with a strong balance sheet, excellent assets and the ability to grow materially without much capital. A few weeks after we bought SemGroup, it was subject to a hostile takeover attempt by another pipeline company. The attempt was opportunistic and the offer price will likely have to be raised for us to sell. We expect this to play out during 2012 and will keep you abreast of any developments.

Bottom line is we believe Ted is a purebred, investment-idea bloodhound and we're stronger with him on our team. He's the fifth reason we think our families will be well-served by EdgePoint.

Long-term advantage

We believe that the shorter people's investment horizons, the greater our long-term advantage. It used to be the case that "short term" was defined as a year. Then, it was a quarter. Then a month. Today, holding periods are defined in milliseconds. Studies show that over 50% of the volume on major global exchanges results from investment strategies that hold their positions for less than a day.

Although this type of high-frequency trading, propped up in part by exotic and ill-conceived ETFs, might sound discouraging, we see it as an opportunity. It's impossible to predict day-to-day, or even quarter-to-quarter stock price movements. That doesn't preclude people from trying. Short-term outperformance envy sucks investors into a cycle of perpetual underperformance. Succumbing to it makes people do dumb things that we attempt to capitalize on.

We rely on our proven approach to investing based on long-term proprietary insights. The greater the volatility created by performance chasers, the greater our ability to add value. We believe we can maintain an edge by taking long-term views in a world increasingly dominated by short-term ones. This is the sixth reason we've invested our family's future in EdgePoint.

Looking ahead

We'd like to thank you for your continued trust and support. As your co-investors, we're excited about the collection of businesses in our portfolios and their long-term prospects. We continue to approach investing in these markets with confidence and look forward to building wealth for you over the long term.

Sincerely,

Tye

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