

Written by Geoff MacDonald

2009 year-end review

While this commentary focuses on the most recent year, I won't spend time dissecting the 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, not on an annual basis. This is not an excuse to hide relative underperformance, in fact we did relatively well over the past year. To us, the typical mutual fund commentary that dissects annual results is simply noise.

The industry's obsession with annualizing quarterly and annual returns is akin to annualizing the score sheet of one inning in a baseball game. Perhaps there is some valuable information about that one inning, but how can this information be used? Can it help you pick the winner of the next inning? Does it matter who wins the next inning? Is the goal to win an inning or to win the game?

Pretend you manage a baseball team trying to win the fourth inning. If there are two men out, you might put in your best pinch hitter hoping he can send one out of the park. The opposing manager then puts in his best relief pitcher, not wanting to cede the fourth inning. Absurd things can happen when you focus on the short term.

Still value in resource stocks?

In the 2008 year-end commentary, we highlighted that we were finding value in resource stocks for the first time in years.

Base Metals

The burst in China's economic activity as a result of its government's quick stimulus actions caused investors to become enamoured with most mining-related equities by mid-year. We were able to purchase and sell companies such as Capstone Mining Corp. (a copper mining company) in a relatively short time period for a relatively large profit. Today, we are having difficulty finding value in base metal mining equities and thus have minimal exposure to the sector.

Gold

Gold's inability to perform during the credit crisis as the world was allegedly coming to an end, dropping like a stone along with most other assets (except the U.S. dollar of course), gave us the ability to purchase and add to positions in a few gold companies. We sold names such as IAMGOLD Corp. and Yamana Gold Inc. at significant gains as investors quickly regained their enthusiasm for gold as the world slowly stopped coming to an end.

The seemingly consensus view that gold will continue to go higher as the U.S. dollar continues its slide has made it difficult to find ideas in this space. We ended the year with only two gold-related investments - International Royalty Corp. (IRC) and Sandstorm Resources Inc. - both gold/metal royalty companies. Royalty companies are much better businesses than mining companies, yet still provide upside to rising

commodity prices with generally less risk. Royalty companies provide capital to mining companies in exchange for payments that are tied to the production of the commodity. As such, they do not incur the same type of operational risk that mining companies are exposed to. In our estimation, both companies are trading for less than the cash flow they expect to generate in the future, unlike most mining companies. IRC recently became a subject of a takeover battle between Franco-Nevada Corp. and Royal Gold Corp. with the two bid prices well over two times our average purchase price.

IRC is a good example of the EdgePoint investment approach at work. The company was sparsely covered by research analysts on “the Street”. This allowed us to take advantage of our idea since the stock wasn’t well known by others. In our estimation, IRC has a “beachfront property” in its line of business with royalties on world-class mines such as Voisey’s Bay and Pascua-Lama, yet this was overlooked by the market. IRC has an incredibly attractive asset base that traded for well under half of what we believed it was worth. Eventually, Franco-Nevada and Royal Gold also recognized this value, and we certainly hope they decide to battle hard for the ownership of this wonderful asset base.

The IRC investment is also an example of the need to continuously search for new ideas. The quick rebound in the gold price and the recent excitement towards potentially higher gold prices, in our view, caused gold companies to become overvalued. It would have been easy to ignore ideas in this space given our nervousness about the “higher gold price” view.

The investment business has many traps that work against one achieving one’s goals. Broad-based statements by portfolio managers such as “we expect the market to tumble below its March low”, or “the Chinese market is overvalued”, or “gold stocks are overvalued” are examples of such traps. These statements can cause portfolio managers to overlook ideas that may otherwise have fallen in their laps.

Take the portfolio managers who expect stocks to tumble to their March lows. Are they genuinely searching hard for investible ideas between now and the possible date in the future where stocks fully retrace? Are the portfolio managers who say the Chinese market is overvalued actively looking for investment ideas in that region? These generalized top-down statements can often put portfolio managers (and their investors) in a bad situation. What if stocks don’t tumble to the March lows or what if China was not overvalued? Are these managers partially blind to investment ideas because of these top-down statements?

At EdgePoint, while we’ll likely never escape from having to provide our opinions on various macro topics, it is our ability to pick stocks that will generate profits for our clients over the long term. Thus, even though the short-term excitement towards gold made us nervous, we were still able to find attractive investments in this space.

Oil & Gas

We continue to be excited with the quality of ideas we are finding in this industry. Two primary reasons for this are the relatively low natural gas prices during the past year and the new technology that is being used to produce oil and gas.

During the past year, the price of natural gas was low due to a number of factors: a warmer than average winter; a cooler than average summer; industrial demand that was falling off a cliff; a glut of new production from unconventional shale gas production; and now what appears to be a warmer-than-average-winter

again! Because of this, natural gas inventories are marginally above their five-year average. Although we recognize that natural gas prices during the next five years are likely to be lower than the past five years, we doubt each year will replicate last year. The lack of excitement towards natural gas stocks and the consensus view that natural gas prices will stay low forever are giving us the opportunity to buy natural gas-related businesses at very attractive prices.

We also have a number of strong ideas in this industry due to the advancement of new technology. Historically, when we looked at an oil and gas company, we would simply value the company's existing reserves. If we had an opportunity to buy those reserves in the ground for less than they were worth, we might have a good investment opportunity. There wasn't much value attributed to exploration because, for the most part, new reserves found during the year from exploration and development generally replaced what was produced during that year. Some companies would do better, while others would be unable to replace production with new reserves. Regardless, the simple math of spending 100% of one's cash flow with the typical finding and development costs of historical drilling technology wouldn't be exciting enough for us to value anything more than the company's existing reserves in the ground (on top of the uncertainty of who would hit the dry holes and who wouldn't).

Today, the ability of multi-frac horizontal wells is changing the economics of the industry. This technology has not only garnered a lot of attention in exploiting the large unconventional shale gas reserves across North America, but is making huge advances in more "conventional" reservoirs as well. For the sake of brevity, we won't go into all the detail of multi-frac horizontal drilling. We'll simply say that oil and gas companies can now economically access known oil or gas resources where the historical vertical drilling could not. With one horizontal well, one can get access to the same amount of oil or gas available from six, eight or even ten vertical wells.

The ability to get access to the equivalent of eight vertical wells from one multi-frac horizontal well in a known reservoir (limited exploration risk) dramatically changes the economics of the business. We've been able to find companies where one year's drilling program can add 20% to 50% to the company's total reserves. This type of growth potential simply didn't exist in the past in this type of business. Until this growth potential becomes better understood, we should be able to continue to find undervalued companies where we aren't paying for this growth. As you can imagine, the opportunities tend to be with smaller-cap oil and gas companies where the reserve additions can be significant to the company's existing reserves.

Financial Services

In last year's commentary, we said "though the banks seem to represent good value when looking out over the next few years, we are finding equal-to-substantially better value across a wide spectrum of businesses". Our opinion isn't much different today. It's tough to have a proprietary view on achieving outsized returns from the Canadian banks today. The world loves Canadian banks, the world loves the Canadian banking system, and the world knows Canadian banks have a strong capital base. Of course, if the world goes back to normal, there will be generous returns available to those who own Canadian banks, but there will be better returns generated elsewhere in such an environment. For example, the large U.S. banks that have rebuilt their capital bases are trading at approximately three times their pre-tax pre-provision earnings. The world's current appreciation for Canadian banks isn't giving us a chance to own our banks at such attractive prices.

Noticeably absent during the past year has been any large investments in life insurance companies. We don't see a scenario where life insurance companies recover to previous profitability levels in the foreseeable future. The desire to maintain higher capital will be a big drag on their return on equity and thus earnings. More importantly, it should be evident that many of the life insurance companies' core products are both less profitable (and many unprofitable!) and much riskier than ever believed by their actuaries. Furthermore, valuations and capital levels are linked to the movement of the stock market and interest rates! Though it should be well known, we're still not convinced that the future of lower earnings potential from higher capital levels and lower earnings potential from less profitable core products is fully understood by the market at this time. Given the large number of moving pieces, we continue to monitor these companies closely.

Idea Generation

Returns over the long term are a function of the quality of investible ideas that one can generate over time. Throughout the year, we've had good success finding what we believe are high-quality ideas. Though we were finding fewer ideas at the end of the year than at the beginning of the year, the quality of the ideas are just as strong. In the first quarter of 2009, we purchased Cogeco Inc., Capstone Mining Corp., Gran Tierra Energy Inc., and NEO Material Technologies Inc. In the second quarter, we found Calfrac Well Services Inc., Exfo Electro-Optical Engineering Inc., and Sandstorm Resources Inc. In the third quarter, we purchased Highpine Oil & Gas Ltd. and Aura Minerals Inc. In the fourth quarter of the year, we added two new names. The first company is benefiting from an in-market merger between its two largest competitors. We suspect significant market share will accrue to this company as it benefits from the market disruption and we believe it has the potential to double in size. The second company is a small oil and gas company that is a pioneer with horizontal multi-frac drilling technology in Alberta's deep basin and has had a 99% success rate during the past five years. The company has a large high-quality land position and we expect its existing drilling targets have the potential to double or triple its reserves. We believe these two investment ideas are as strong as any of the previous ideas we've added to the Portfolio earlier in the year.

A year too early?

A number of our better investment ideas representing some of the Portfolio's larger equity positions such as Boralex Power Income Fund, Exfo Electro-Optical Engineering Inc., Thomson Reuters Corp., and Tim Hortons Inc. are ending the year at prices very similar to their cost base. In a year with such large stock returns, were these investments mistakes? At this time, we'd be in the camp that perhaps we were a year too early on these names.

With regards to Boralex Power, we believe we are not paying for approximately half of their power-generation capacity. The continued deployment of Fibre To The Home (FTTH) technology and fibre backhaul requirements from all the cell sites in the world should drive Exfo's business for the next decade. With Thomson Reuters, a large portion of the \$1.5 billion in merger synergies will flow through to the company's earnings in 2010 and 2011. These synergies should drive significant earnings growth during the next couple of years. In the case of Tim Horton's, we expect its U.S. operations will start to show profitability in 2010. This should help highlight a significant asset that isn't being valued by the market.

Fear the opportunity

In last year's commentary, we asked our investors not to fear the opportunity that the bear market was providing. Outsized relative returns tend to happen at times of market extremes (at both tops and bottoms). For example, think of the relative outperformance you would have had in the 2000 to 2003 time period by simply avoiding stupidly-priced technology stocks. Or think of your relative outperformance in 2009 by simply believing the world wasn't coming to an end.

We all know how to make investments if the world turns out the way we think it will. Last year was no exception. Any investor who believed the world wasn't coming to an end would have found it hard to not make at least a twenty per cent return (or much higher if you were investing in Canadian equities) in 2009 and the opposite scenario is also true. Last year was simply one of those years that provided the opportunity for outsized returns. And like all other market extremes, there was just one decision that had to be made. In this particular case it was "is the world coming to an end?"

Today, fewer people believe the world is coming to an end and thus there are substantially fewer sellers of quality companies at stupid prices. While this is unfortunate, it shouldn't be a surprise to our investment partners. The good news is we are finding few investors who are excited about the future. Investors seem to be worried about a number of things such as: how quickly stocks have moved; inflation; deflation; government debt levels; the consumer; whether stocks will go back to their March lows; high unemployment rates; currency; or rising interest rates.

These "worries" mean there are few investors who are optimistic about the future and therefore, there are few investors who are willing to pay for growth potential. This means you can buy stocks today without paying for the growth.

Outside of buying a business from a seller who thinks the world is coming to an end, we'd suggest the next best situation would be buying a business from a seller who had worries about the future and ignored the growth potential of his business. That is where we believe we are today and that is a great place for the EdgePoint investment approach.

Fixed income comments

The fear that existed in the first half of 2009 caused investors to sell anything that they perceived as risky – both equities and bonds. As investors braced for the worst, many forecast that solid businesses with strong balance sheets would not survive the downturn and proceeded to sell corporate bonds. The selling pressure caused prices to free fall and credit spreads to widen to levels not seen before. Investment grade spreads widened from their historical average of 200 basis points (bps) over government bonds to 600 bps and high yield spreads jumped from 600 bps to 2000 bps.

We viewed this as an opportunity to selectively buy the corporate bonds of well-capitalized companies that we were confident would survive the downturn. Throughout the year, our fixed-income exposure remained fully invested in corporate bonds. This proved very rewarding for our investors as corporate bonds outperformed government bonds by a large margin.

Sotheby's is an example of a well-established business that operates in an attractive industry and is protected by high barriers to entry. Over the last 250 years, they have developed a rock-solid brand and have survived countless economic cycles. At the beginning of 2009, investors predicted that the economic downturn would cause the high-end auction market to disappear. After thorough analysis, this market irrationality enabled us to buy Sotheby's convertible debt at 50 cents on the dollar. The timing was uncertain but we were confident that the economy would recover and that art enthusiasts would continue to buy high-end masterpieces. We were correct in our thinking and the market began to agree with our thesis bidding the convertible bonds up to par.

After a strong performance in 2009, it has become more difficult to find attractively priced debt investments. We believe there are still opportunities in the corporate bond market that our thorough research can uncover and that is where we will focus our attention in 2010.

Sincerely,



Geoff MacDonald

Commentary as at December 31, 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.

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