Written by Geoff MacDonald

While this commentary may focus on the most recent quarter, we don't pay any attention to relative results over such a short period of time. Over the long term, business values and market values tend to be more closely aligned. Thus, we will try to focus our comments on the operating results of the businesses we own and/or the factors that impact their long-term values. We will also add other insights that may help you become more informed about the Portfolio and our investment approach.

Market Loves Resource Stocks Again

We often talk about the futility of timing the market. In my last EdgePoint Canadian Portfolio commentary, I included a section called "Finally Finding Value in Resource Stocks". I talked about how it was the first time in over five years that we had been so excited about the value in the resources sector. However, I went on to say that "*if we were to guess.......it is very early to get too excited*".

I outlined a case on why I thought we wouldn't have a rapid bounce back in resource stocks to their recent highs. But, we ended the section saying *"Money is made by buying businesses at values well below their long-term worth, and we're starting to find companies whose valuations are low enough that we'd be content holding the investments for years".*

I highlight these quotes to reinforce our investment approach. The majority of investors tend to focus on where things are heading. They try to make predictions about the unpredictable, such as interest rates, currencies, economies or the timing of a turn in the markets. We are constantly asked "where things are going", but are never asked "what is this business worth". While our expectation (or perhaps guess) on the resources sector was that it would be a long time before stocks became favourable again, we felt it was much more important to take advantage of the opportunity to buy businesses at prices lower than their true worth. We were fortunate to do so, as there has been a dramatic increase in the market's expectations of these businesses' prospects, reflected in higher stock prices. We'll later provide an example of one such company which we bought and have already sold.

We will always have views about various economic factors such as inflation and interest rates, but it is important to understand that these are simply opinions, not facts. We will always consider the impact of inflation or a prolonged recession on the businesses we own in order to ensure that we do not take on undue risk within a portfolio (i.e. all investments negatively exposed to the same negative outcome). But having an idea about a business, which is not widely understood by others, and which is trading at a price for less than its worth, is the key to long-term investment success.

Futility of Forecasting

Short-term forecasts are simply guesstimates that should not be relied on for investment purposes. There are far too many variables to consider, and no system has yet been invented to help predict such things as interest rates, currencies, market movements or GDP growth, without revisions of course. I'm sure there is a reader out there saying "There was that guy last year who got it bang on", or "I remember in 1993, I predicted almost everything perfectly". The reader may be correct as this sometimes happens. But, both were nothing more than luck.

We know it is luck because we're not aware of anyone who has been able to consistently make such forecasts with any degree of accuracy over time. A stopped clock is right twice a day, and even the weatherman gets it right sometimes.

Another interesting factor to consider is that an accurate forecast about the economy (which we would argue is just luck) tells you nothing about how the market is likely to react, and even less about how a particular stock may react. Though there will be doubters who mistake their luck for brilliance, we could name countless examples of markets reacting "unpredictably" to accurate forecasts.

Think back to 2007 and imagine successfully predicting that major U.S. financial institutions, such as Citigroup Inc. and Merrill Lynch & Co. would drop by more than 40%; that banks would have more than $100 billion in write-downs; that oil could jump to nearly $100/barrel; and that consumer confidence would plunge to levels only seen in previous recessions. The accurate forecaster would have likely predicted that the Dow Jones Industrial Average and S&P 500 Index would have fallen in reaction to the news. On the contrary, markets were higher in 2007, bringing into question the value of an accurate forecast. The same could be said for the first six months of 2009. Would an accurate economic forecast have been helpful in predicting the level of the stock market on June 30th? It does make us wonder why investors preoccupy so much of their time forecasting economic variables because (1) they are unpredictable and (2) when you do happen to get it right, you may still be wrong about the stock market.

What if a system was developed to accurately forecast the future and the direction of the stock market? If such a system existed, you would still not make any money. Each investment would earn a risk-free rate of return. Buyers and sellers would always agree on a price because both parties would know what the future holds. Any changes would then be immediately discounted into the stock price eliminating any profit opportunity.

The inability to make accurate forecasts is what creates a market and it is this uncertainty that creates the opportunity for returns. So why base your returns on luck or on short-term economic forecasts?

Ask About the Entry Price, Not Where Things Are Going

Your entry price will dictate your return, yet no one talks about it. It's one of the most puzzling things about investing. You rarely hear market participants talk about what a stock is worth. Instead, people focus on where its stock price is going, which is very difficult to predict with any degree of accuracy.

Investors tend to only treat investments in this manner. With other products and services such as cars, electronic goods, haircuts etc., people understand the price to value relationship. If the prices of these items were to triple, they would likely not be purchased. Stocks, on the other hand, would have an equal or greater chance of being purchased after they've tripled in price.

How should one attempt to prosper in an uncertain world where forecasting is impossible (or a waste of time)? We believe the stock's entry price, coupled with the assumptions necessary to justify the current price, is much more important than attempting an accurate forecast.

Access to all available information is also extremely important. If everyone holds a common belief about something, then it becomes immediately reflected in the stock price. Knowledge is only beneficial if it allows you to have an investment idea that is not well understood by others. When we find such an idea, then we will likely get the entry price right.

Capstone Mining Corp.

Although we guessed that it would be many years before commodity prices and resource stocks would rebound dramatically, these beliefs did not prevent us from buying businesses that we believed were attractively valued. Given how low many of these stocks were trading, the rest of the market must have had similar views on the unattractive short-term outlook for resource equities.

For example, in January 2009, we purchased a stake in a copper producer called Capstone Mining Corp. Capstone is a Canadian mining company primarily focused on copper production and has two wholly-owned mines: the Cozamin mine in Mexico and the Minto Mine in the Yukon. The company also owns an advanced-stage copper prospect called Kutcho in British Columbia. On November 24, 2008, Capstone acquired Sherwood Copper Corporation, which roughly doubled the size of the company.

The opportunity to invest was in the short time-frame prior to when the analysts completed their research on the merged company. Prior to the merger, there was very little information available in sell-side research reports. Analysts seemed to be waiting for the merger to be finalized and the combined financials to be released before writing about the combined company's assets and earnings power. It wasn't until April of this year and after a big move in the stock price, that analyst coverage picked up significantly on Capstone. This gave us a small window to perform our own research before the rest of the market.

Our analysis showed that following the merger, there would be 164 million shares outstanding. Capstone's stock price, at the time of our analysis, was approximately $1.00 per share (down from over $5 per share). Net of the company's cash and investments, the newly merged company would have only $50 million in debt. This gave the company an enterprise value of $214 million ($164 million plus $50 million).

We liked the quality of Capstone's two operating mines and its healthy balance sheet. The company also had a strong hedge book, which would help insulate future cash flows in what looked like a tough economic climate in the following couple of years. The hedge book would allow Capstone to continue to thrive even in a tough economic environment. Strong cash flows from operations would allow them to expand their resource and production levels, and advance the Kutcho project toward production. Most other mining companies were reigning in exploration budgets and shutting down production, while Capstone was positioning itself for growth, allowing it to come out of the down cycle stronger than when it entered.

Capstone's hedge book had an outstanding balance of copper-forward sales totalling 104 million pounds, at an average price of US$2.52 per pound of copper, deliverable over the next four years.

As I'm sure you clearly recall, there was tremendous fear in the market at the end of 2008 and the beginning of 2009. When fear is overly discounted into stock prices, you are often able to find tremendous buying opportunities. We investigated this fear when we considered an investment in Capstone.

The worst case scenario for a company that only produces and sells copper would be if copper prices were to go to zero. It is difficult to imagine a worse scenario! Should the world never find use for copper again, Capstone could sell their 104 million pounds of copper for US$2.52 per pound and pocket US$ 262 million.

They would just shut down their mines and deliver the worthless copper that they were able to purchase for zero. These proceeds would be greater than the enterprise value of the company (C$214 million)!

Though this example may not be realistic, it is certainly instructive in highlighting the value of the company should the worst possible scenario take place. The fear in the market allowed us to buy this company for less than its potential worth in an improbable worst case scenario.

Unfortunately, our holding period in Capstone was less than six months. Though we hope to hold our investments for at least three to five years, recent extreme volatility in the market gave us a chance to earn five years worth of return in a few months. We purchased Capstone at an average price of $1.10 per share. Within a matter of months, the share price reached $2.40, a return of 118%. To justify holding this investment at $2.40, one would have to have expectations for a quick economic rebound, insights on China's future growth potential, and a thesis for how copper prices could stay above US$2 per pound. We did not have such strong convictions on these matters but we assume that the purchasers of our shares of Capstone did.

Sincerely,

Geoff MacDonald

Investment Results

In accordance with the Canadian Securities Administrators' National Instrument 81-102 under which the Portfolio is governed, 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.