Written by Tye Bousada

A great business is not enough.

One of our partners from Nova Scotia asked us the other day what is the first thing that we look at when we begin evaluating a business. Our answer was "risk". This partner then followed up by asking if our focus on risk resulted in us being biased towards a collection of well-recognized "great businesses". We explained that this was not our approach, and if history is a guide, buying today's recognized winners could get an investor into a lot of trouble over time.

We have written extensively about our investment approach in the past, however, it is worth briefly reviewing. Our approach is focused on developing proprietary insights around businesses we understand, and that are led by trustworthy and competent management teams. We look for companies that have long-term growth prospects and defendable barriers to entry, leading to attractive return characteristics.

What we don't do is buy a business when the "perceived risk" is low or when everyone is in love with it. We define risk as permanent loss of capital. History has shown that the chance for permanent loss of capital is usually the highest when "perceived risk" is the lowest. Think about buying a technology fund in 1999 because "technology companies were going to own the future and their share prices would only go up". Or, buying a 30-year government bond in March of this year when the consensus view was that their perceived risk was very low. The truth is both the technology fund in 1999 and the 30-year government bond in March 2009 were opportunities for permanent loss of capital. The investors that bought either one of these investments will likely not get their money back after accounting for inflation over the long term. Some of you may be wondering how it is possible to lose money on a government bond over 30 years. The answer is that if inflation is greater than 3% on average over the next 30 years, then you will be poorer in 2029 than you are today because your purchasing power has declined.

The important point, however, is that at the time of purchase, the perceived risk in both investments (the fund in 1999 and the bond in March of 2009) was extremely low, yet the real risk was very high.

We focus our efforts on uncovering and understanding the real risks in a business and worry much less about its perceived risks. A good proxy for real risk can be the price the market is asking you to pay for a business. Real risk and the potential return of an investment are simply derivatives of this price.

Thomson Reuters Corp.

Thomson Reuters, one of the largest positions in your Portfolio today, is a good example of how we approach real risk. The company is a collection of what we believe to be attractive businesses. The market, however, perceives its short-term risks to be high and have bid down the price of the stock. In the past, we shied away from owning Thomson Reuters because for much of the past decade, the market regarded Thomson Reuters as "a great business", and as such, was willing to pay a steep price to own it. Stated another way, historically, the "perceived risk" in Thomson's business was low. This led to a situation where its valuation rose to what we felt was an unreasonable level.

The low perceived risk in Thomson Reuters over the last decade resulted in real risk for investors. Here is the math behind the real risk: 10 years ago, when everyone thought it was a great business, Thomson Reuters was $41 per share. Today, the price is in the high $30's. So if you had owned this company over the last 10 years, you would have lost money (before dividends). An investor in Thomson Reuters was exposed to a high degree of real risk during a time when the perceived risk was low.

More recently, the market's perception of its risk has increased dramatically and concern is centred on its short-term outlook. Specifically, the company generates the bulk of its revenue and profits from selling data to lawyers and financial industry participants, data that is considered essential to their profession. Furthermore, there is a lack of competition. There is only one significant competitor in each of these industries, which provides Thomson Reuters with significant pricing power and very attractive underlying economics to its business. Recently however, the market has become concerned about its short-term outlook for growth given the poor state of the economy. The worry is that in the short term, fewer lawyers will enter this business and fewer jobs will be available in the financial services industry, resulting in weaker demand for their data services. These concerns have increased the perceived risk of Thomson Reuters, driving down its share price.

Looking beyond the short term and focusing on the next four to five years, we believe that there will be more lawyers and financial industry participants in the world. We also believe that not only will there be increased demand for their data, but users will have to pay a higher price than they do today. As a result, we feel the long-term outlook for the company is extremely attractive. This is the first time in a very long time that we have owned Thomson Reuters. Because its perceived risk is very high, its share price has been driven down to a level we believe represents an attractive valuation. This has reduced the real risk in owning Thomson Reuters and has increased its expected future return.

In summary, we are attempting to approach investing in these turbulent markets with a sense of measured confidence. We will continue to focus on the real risk inside of a business while trying to capitalize on opportunities in the market created by perceived risk.

We thank you for your confidence in us, and look forward to having the opportunity to build wealth for you over the long term.

A Final Note on HST

Many of you are aware that the McGuinty government is proposing to harmonize the 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,

Tye Bousada

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.

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, Geoff MacDonald and I will 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.