

Written by Geoff MacDonald

A Night with the Bears

It was one year ago today, on April 7th 2009, when an event occurred that should remind all of us of the self-destructive nature of investor behaviour. Hopefully some participants at the event and others who read about the event married the silliness of what they witnessed with an ounce of stock market history.

I can almost guarantee that you spent some time reading or hearing about this event. My certainty is because of the attention it garnered. There was a story in the newspaper on April 1st, 2009 prepping you for it. There were more articles on April 2nd, April 3rd, April 4th, and April 6th! What must have been happening in the world on April 5th to have missed another opportunity to write about this event is beyond my imagination. This event was so big that one of the participants was interviewed on George Stroumboulopoulos' "The Hour" on CBC the night of the event. It was even big enough to have the entire event twittered (or is it tweeted?) by a reporter. The event was also dutifully covered posthumously by many of the major news outlets.

1500 people strong filled a theatre to its capacity to listen to "the Bears". There, they learned what everyone (including themselves) already knew. There was nodding heads as they heard about how bad the economy was, how shallow any recovery would be, and how we're likely entering into a long drawn out depression. Heads would have moved in unison as there was talk about zombie banks and the messed up U.S. mortgage market. Socializing around the open bar, attendees were bragging about when they exited the market and were relieved to hear their allocations to cash, gold, and double-levered ETF index shorts were in line with what everyone else thought was advisable. No opinion had more universal agreement than the opinion about the recent rise in stock prices ... of course it was just a bear market rally. I won't even mention the forecast of the Dow going to 1000 and the like.

A few attendees were students of stock market history and were smart enough to realize that they were witnessing "the crowd". Those who don't think this was "the crowd" should become students of stock market history. Investing with "the crowd" has always been a sure-fire way of either losing a bunch of money or a guaranteed method of not making any money in the largest stock market rallies of our history.

The event is one more reminder of how complicated "investors" try to make the stock market. We believe the stock market should simply be viewed as a meeting place where business people can buy or sell an ownership stake in a business. Unfortunately, most stock market participants have made the stock market much more complicated than that.

To help further explain this topic, I would ask you to think of the three or four richest people or families you know in your town. Do the same in your neighbouring town. Then think of the 10 or 20 richest people or families you are aware of in the world. How did these people amass their wealth? I'd be willing to speculate that they amassed their wealth by owning a quality business or two over many years or even decades. There is no better (or easier) way to build wealth over the long term than to own quality companies that were initially purchased (or built) for a reasonable cost. This will never change unless capitalism, as we know it, ends.

If, year-after-year and decade-after-decade, the people most successful in amassing wealth have done it by owning a quality business or two, and if everyone in the world has access to the stock market where he or she can buy a quality business or two, why do “investors” play so many crazy games with their money to the detriment of their own pocket book? Unfortunately, the average investor never achieves the returns of the broad market indices over the long term, and certainly never obtains the even higher results that can be realized by simply owning the above-average investable opportunities that are always available.

Mr. B

I will ask a series of questions that have obvious answers on this seemingly confusing yet simple topic. For these questions, consider the average business person I asked you about a couple paragraphs ago and for simplicity, let's call him or her Mr. B.

Would Mr. B buy a business because he got a tip from a friend? Imagine the lunacy for a minute that Mr. B actually amassed his wealth by buying businesses based on tips he received from friends!

Or imagine that Mr. B decided not to try anymore. Instead, a friend pitches him on the concept of owning every business in the economy. His friend calls it an ETF index fund. The idea is that no one has the skill to build wealth over the long term better than a person that just bought a bit of every company in the economy. In addition to owning some very good businesses, Mr. B now owns frauds, companies that will eventually go bankrupt, companies that are priced for perfection, businesses he generally dislikes, and businesses run by incompetent managers. Mr. B has taken all his money and put his blind faith in no one (or is it in everyone?). And for the right to put his blind faith in no one, he pays a supposed low fee. I don't have to even ask how absurd it is to think Mr. B would do this.

Another absurdity of the stock market that helps separate people from their money is a high turnover rate. Pretend for a minute that Mr. B decides to only own his businesses for a six-month period. He buys a retailer, then sells it six months later and invests the proceeds in a tire manufacturer. Six months later, he sells the tire manufacturer and buys a gold mine only to sell the gold mine in six months to buy a trucking company. How long will it take for Mr. B to lose half his money? It's interesting that most market participants, on average, own a business (purchased on the stock market) for less than one year, yet those same participants would agree that Mr. B is likely to lose half of his money within a few years.

Perhaps after amassing his wealth, Mr. B decides there are other successful methods of growing wealth and starts studying stock charts. His stock chart buddy gives him tips and shows him that when certain squiggly lines intersect other squiggly lines, it's historically a great buy signal. How much wealth will Mr. B. now amass if he doesn't ask about the business' management team, competitors, growth prospects, or the price he has to pay relative to the worth of the business; and simply buys businesses because squiggly lines intersect?

My favourite question, which ties back to my earlier comments about that big event last year, is: Would Mr. B have sold his business last year at a very low price simply because people were worried that other businesses would decline in value?

Mr. B amassed his wealth because he owned quality businesses over the long term and he viewed a stock as a business, not a piece of paper. The biggest mistake investors make is they view a stock as a piece of

paper that goes up or down. If you view a stock as a piece of paper (rather than the business that it is), then you risk doing silly things with your money. No one in their right mind would buy a business because a couple of squiggly lines intersected, yet they do it with stocks all the time. Pretty amazing!

Mr. B, EdgePoint, and others are free to take advantage of this self-destructive nature of investor behaviour. Think of the excitement we have when we can buy a stock (i.e. a business) from a traditional index fund! The index fund may be selling for a variety of reasons, but none of those reasons has to do with the fundamentals of the underlying business! The index fund manager doesn't know the management team or even have to understand the business. The index fund doesn't ask if the stock is cheap or expensive. The index fund doesn't ask if the company is growing or shrinking. Can you imagine how much money someone could make over the long term by buying or selling businesses to an index fund! Though you may feel sorry for index fund investors after thinking about this example, it was their choice to put their blind faith in no one ... for a low fee.

Today, it's our belief that the average investor looking at "stocks" is still worried about the future or is worried about how much "stocks" have moved in the past year. We continue to hear questions and witness fear about the following items: inflation, Greece, a weakening Euro, fiscal deficits, deleveraging banks, deflation, weak employment, or the over-levered consumer.

We don't want to downplay these issues, as they are all legitimate concerns. However, these fears tend to reduce the market's expectations of the future. Because market participants are less excited about the future, they are less likely to pay for future growth potential. Because of this, companies are often priced at levels that assume very little growth in the future.

Just as you can legally take advantage of the index fund manager by buying a business from him that he knows nothing about, you can search the investable universe for companies that are likely to be twice their size in five to seven years and buy it from investors whose fears about the future cloud their view of the merits of individual businesses.

Investment opportunities

We continue to own and find companies which have significant opportunities for growth, yet whose stock prices are trading at values in the marketplace which reflect dim growth prospects. In early March, Tye & I spent a week in Japan looking for interesting Japanese investment ideas. We were fortunate to find two companies that we've been buying in the portfolio. Both companies are trading for significantly less than what you could have purchased them for a few years ago. They are both number one in the world in most of their business lines with significant growth opportunities ahead of them. Due to investors' uncertainty about the future and a general distaste for Japanese stocks, we are able to purchase them for trough-type valuations.

Recently, we spent a week in Florida at a U.S. small and mid-cap conference where over 250 companies were in attendance. We are now sifting through the companies that we met and are completing our due diligence on a few of the best investment ideas. We'll likely see a couple of these companies find their way into our portfolios over the next quarter.

We also have some trips planned for Europe in the spring of this year. The Portfolio currently has minimal direct exposure to European businesses. We don't have an aversion to European companies; we've simply been finding better opportunities elsewhere. Part of the reason we've been having difficulty finding ideas in Europe during the past year is because many European businesses are losing their relative competitiveness. The realities of this global recession and the possibility that the economy could be slower for longer than most people believe have meant that companies need to adjust their cost structures. The companies we own have done this and will be much stronger coming out of this recession than they were going into it. In Europe, however, it is generally more difficult to cut costs. It is difficult to shut down plants, lay off workers, etc. Often there is simply an unwillingness to do so. I'm not saying this is right or wrong; it's just a fact. The strength of the Euro over the past few years has magnified these cost structure issues and has made the average European company less attractive when compared to the past. To be clear, we haven't avoided continental Europe because of this view. When we did spend time on companies we know (and many we used to own), we found them to be much less attractive compared to other investments that we could find. A weakening Euro and lower European stock prices, however, could change our view.

We'll report back after our upcoming trips.

Fixed income comments

North American fixed-income markets were relatively immune to the risk aversion seen in Europe that was brought on by Greece's struggle to issue new debt. Corporate bond spreads continued to tighten throughout the first quarter of 2010.

There are significantly fewer opportunities in the corporate fixed-income market compared to this time last year, however, we have been able to participate in numerous new issues and continue to uncover solid businesses that are trading at attractive levels. Corporate bonds continue to make up the entire bond component of the portfolio. As with all our investments, preservation of capital is our primary concern and we are focused on not taking unwarranted risk in search of higher yield. We have confidence that we will find opportunities where the market is mispricing securities and will invest with conviction behind these ideas.

Sincerely,



Geoff MacDonald

Commentary as at March 31, 2010. 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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