

## **EdgePoint Canadian Growth & Income Portfolio**

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One of the commitments we have at EdgePoint is that we will communicate with our investment partners regularly and honestly because informed investors and advisors can make better decisions.

In addition to discussing our Portfolio, we'd like to use this first commentary to help set expectations for future quarterly and annual commentaries. While we aim to exceed the performance of the major indices over long periods of time, we do not pay much attention to relative results in any given year, quarter, or in this case, 6-week period! Although our comments may focus on the most recent quarter or year, we do this only because it reflects industry convention. Under no circumstance does a three-month period give enough information for setting long-term return expectations for returns for any investment strategy. Nor do we subscribe to the notion that quarterly price movements of our portfolio investments have much correlation with the longer term value of these investments. Over the long term, business values and market values tend to be more closely aligned. Thus, we will try to focus the majority of our future commentaries on the operating results of the businesses we own and/or the factors that can affect their long-term values.

In this commentary, we won't recount the economic events of 2008. I'm sure each investor and advisor has spent more time reading about the economy and the stock market in 2008 than the past 5 years combined. We will address our views and our investments in financials and resource stocks (which combined, makes up the majority of the Canadian market), and other areas where we are finding value.

### **Finally finding value in resource stocks!**

For the first time in years, we are finding some value in resource-related companies in Canada. If we were to guess, however, it is very early to get too excited. Having said this, we haven't been this excited in well over 5 years. However, our approach is measured and reserved.

First, resource stocks have only recently imploded from the largest bubble this sector has seen in generations. After the pricking of a large bubble, stocks tend to take much longer (years and often decades) to fully recover. If history is a guide, investors should have lots of time before the next commodity bull cycle.

Secondly, resource stocks tend to be very late-cycle performing stocks. Look no further to the recent run-up and fall of these stocks. Investors tend to get most excited with resource stocks when their respective commodity inventories are in short supply. That happens late in the cycle when the multi-year demand from expanding economies starts to exhaust the large commodity inventories that were built up during the prior downturn. Investors should not be surprised to see a dramatic rise in inventories during this global recession that will likely take years to deplete again.

Thirdly, many resource company management teams built balance sheets expecting the high commodity prices would last for a couple more years. Should commodity prices stay around current levels for 2009,

the shareholders of these over-levered companies will likely see their stock head towards zero, or be diluted by rights issues.

Fourthly, we fear that some big engines of growth for these sectors during the past couple of years (i.e. China & India) will not be as healthy as many people think and won't be in a position to bail out commodity businesses. For example, we fear that China's main problem is that its GDP is too skewed to investments and exports (approximately 40% & 35% respectively) and not enough to consumer spending. In all economies, private consumption is the most stable component of GDP as a large amount of household spending is non-discretionary (we believe this is one of the underestimated benefits of the U.S. economy versus the Chinese economy during the present downturn). Approximately half of China's GDP in the past few years has been made up of investment spending. This spending was fuelled by foreign direct investment (FDI) and government-owned banks loan growth of over 20% per year to many Chinese companies with suspect profitability. We believe one is right to question the sustainability of these forces during this downturn. Some investors may point towards expected stimulus packages in China. We certainly hope this stimulus can offset likely drops in investments (such as FDI), but can you stimulate an economy by building another steel mill or another building or another road when many are sitting empty? With the investment component of GDP looking suspect, the next most important component to keeping things afloat is exports. How do you increase exports in a global recession? Is it possible that exports actually decline? Thus, China is left with trying to increase local consumption (unfortunately the smallest component of GDP) to offset the likely aforementioned shortfalls. Can the Chinese stimulate this small piece in the face of the negative wealth effect of a stock market down over 60%, housing price corrections, and job losses? Of course we don't know the answers to these questions, but it is reasonable to assume that China may not be the same engine of growth during the next couple years as it was during the past few.

Because India has over 1 billion inhabitants as well, it is also worth a quick mention. With a budget deficit of approximately 8.4% and a current-account deficit of approximately 3.5% of GDP, we're unsure that the math adds up for a stimulus package during a global slowdown. Getting loans for their current largesse will most likely be India's primary focus for 2009.

To us, it seems probable that we won't have a rapid bounce back in resource stocks to recent high levels. We suspect we will be talking about years for these stocks to get back to where they were a short 6 months ago. But 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. Resource and resource-related companies represented approximately 16% of EdgePoint Canadian Growth & Income Portfolio at the end of December 2008.

### **Deleveraging and Our Banks**

Deleveraging is a very simple concept to understand, but much more difficult to know when it will be complete. As the banks de-lever, there is a higher cost and less debt available to the real economy. This forces corporations to reduce leverage by selling assets, reducing investment or raising equity. This also forces consumers to reduce debt (many by selling assets). This reduction in investment and consumption lowers economic activity placing stresses on corporations and individuals, which in turn

sets off defaults that trigger losses for the financial system that further reduce lending capacity or forces the banks to raise more equity. De-leveraging continues through these iterations until overall levels of debt reach a point supported by cash flows available to service the debt and/or asset price levels.

We suspect the Canadian banks are greater than halfway through this deleveraging process. The process would be complete if not for future potential losses. Canada has entered into a recession later than much of the rest of the world. We're seeing real signs of home prices and home-sale activity dropping, and a slowdown in business activity across much of the country. If the banks were to experience similar losses in this recession as previous recessions, their earnings would drop another 30-50%! Much of this fear is already reflected in current stock prices. The recent increase in equity issues by Canadian banks highlight that perhaps the bank management teams also see this coming. The entire world has seen the global trend towards banks holding more capital to back their loans. Unfortunately for Canadian bank shareholders, bank management teams decided only recently to follow this trend. Why did the banks wait for their stocks to drop substantially before building their capital from already supposed high levels? It is only prudent to suggest they see credit losses increasing.

Canadian banks appear incredibly "cheap" with their high dividend yields and low (approximately 7 -8x!) P/E ratios. However, such a drop in earnings (the 30-50% mentioned above) would place the banks at closer to 10-14 times trough earnings. A respectable valuation if you have a long-term view. With history as a guide, should this recession be like past recessions and should our banks trade at valuations seen in previous recessions, we'd be looking at adding to these companies at even better prices during the course of this year.

We took positions in three banks by year end which represented approximately 7% of EdgePoint Canadian Growth & Income Portfolio. Though the banks seem to represent good value when looking out the next few years, we are finding equal-to-substantially better value across a wide spectrum of businesses.

### **Large-cap stocks look attractive, but look at small-caps!**

One of the predominant areas where we are finding tremendous value is in small- to mid-cap stocks in Canada. The discrepancy between small-cap valuations and big-cap valuations is wide in Canada, and interesting, this discrepancy doesn't show up globally. The chart below shows the Canadian small-cap valuation discount relative to its big cap peers:

	Large-cap index	Small-cap index	Relative Large-cap overvaluation
Trailing P/E	11.4	10.3	10.7%
Trailing P/CF	6.3	4.8	31.1%
Trailing P/B	1.7	1.1	54.5%
Average			32.1%

Source: CIBC World Markets

Of the 37 Canadian names in the Portfolio, 18 have market capitalizations of less than \$500 million. Another 5 names have market capitalizations between \$500 million and \$1.5 billion. We have not seen such value in Canadian small- and mid-cap stocks since 1998. Given our recent start only 6 weeks ago, our Portfolio is small enough to take advantage of this valuation discrepancy.

We've attempted to keep most of the smaller names out of the top ten portfolio holdings as we've had positive net sales in our Portfolio and we'd prefer to be able to continue to accumulate these companies for our investment partners (unitholders) at these attractive valuations. Exposing these names to the public at this point would not be in the best interest of our investment partners.

### **No value in government bonds**

At the end of the December 2008, EdgePoint Canadian Growth & Income Portfolio had a 21% investment in fixed income. 100% of this was in corporate bonds. With 10-year Canadian government debt yielding less than 3%, we're uncertain how earning only 3% before fees for the next 10 years can be considered an attractive investment. Corporate spreads have widened dramatically during the past year. We own very high-quality corporate debt that is yielding 250-450 basis points above treasuries. Many of our balanced fund competitors typically own a large allotment of low-yielding government bonds in their funds. We believe our bond exposure, combined with our lower-than-average MER, gives the Portfolio a nice head start for 2009.

### **Opportunity**

This past year has been trying for many investors. We believe the key is not to fear the opportunity that this bear market is bringing. The common similarity you see in all bear markets is this "fear of opportunity". Basic economics suggests that when prices for goods or services are low, demand increases, but as prices rise, demand declines. If you offer a lower price, you will attract more buyers. Unfortunately, for the average investor (but fortunately for us) the opposite seems to be true in the investment world. We can recount many stories of how higher prices attract more investors. Crazy as it sounds, just as high prices attract investors, low prices scare them off! You will hear from us many times over the ensuing years that the best way to make money is to own outstanding companies run by capable and trustworthy management. But the long-term returns from even the most outstanding companies are completely influenced by the price you pay for them.

This bear market has brought with it substantially lower prices (like all other bear markets). These lower prices are providing select opportunities to find outstanding companies at values that should allow substantial long-term returns. Given the slowdown around the world, however, we are attempting to buy businesses that will be "survivors". We have shied away from businesses with a material amount of leverage. Furthermore, we are attempting to buy businesses that can grow even in the face of a tough economy.

We are finding high-quality companies trading at prices which are substantially below their true worth and substantially below their replacement costs. This discrepancy between stock market value and underlying business value is unsustainable and the eventual closing of the gap should provide our investors with a substantial gain.

We thank you for your confidence in EdgePoint, and we look forward to a mutually profitable relationship in the years to come.

Geoff MacDonald

**Investment performance**

In accordance with the Canadian Securities Administrators' National Instrument 81-102 under which the Portfolio is governed, we are not permitted to discuss investment performance until the Portfolio is one-year old. This information, however, is readily available from publically-accessible websites and newspapers.