Written by Tye Bousada

Mental Habits

Keep it simple, remember what you set out to do, and stay in a narrow emotional band. These sound mental habits are always important to adhere to, however, rarely were they more important than in 2009. Last year saw capital markets deliver volatility not seen since the Great Depression. We realize that we don't need to provide a blow-by-blow recap of the year in this letter because you lived through 2009 just as we did. However, we believe it is important to highlight what helped guide us through these markets. Specifically, we stuck to our deceptively simple investment approach; we remained focused on our goal of building wealth for you over the long term; and finally, we tried to combat the primal instincts of fear and greed on a daily basis, or said another way, we tried to live as best we could in a narrow emotional band.

With these mental habits as a backdrop, let's begin our discussion of how we approached the responsibility of managing your money in 2009, and how we will do so going forward. To help guide our thoughts we have broken up our annual letter into the following sections:

1. **One year ago**
2. **Changes to the Portfolio during the year**
3. **Is it over? Did I miss it?**

Part 1 - One year ago

The general question facing the investing public one year ago was "Is the financial system going to collapse, thus leading to the end of the world?" Although this question might seem silly from where we stand today, the risk seemed very real to many people a year ago. Facing this crisis, and with history as a guide, we determined that judgments made about what not to do were equally as important as actions taken. In our judgment, the complete collapse of the global financial system was not a likely outcome considering that in the history of modern civilization, it had not happened before. Furthermore, the general consensus was that it was going to happen, and as the old adage goes "When everybody knows something to be true, nobody knows nothin".

The immense wall of fear in the market created what we believed to be a buying opportunity, however, we knew that we had to be very selective. Not only did we want to avoid the obvious "safety" businesses, but we also wanted to avoid the businesses that needed the economy to grow in order to propel them.

History has shown time and again that during times of extreme fear, equity market participants migrate towards a handful of "safety"-type businesses. Specifically, they feel safe owning pharmaceutical companies because consensus thinking is that no matter how bad the economy gets, people will always need to buy their blood pressure medication. They also feel safe buying grocery stores and packaged goods companies because the consensus thinking is that no matter how bad the economy gets people will still shop for food and need to brush their teeth. Finally, they feel safe owning utility and telecom companies because consensus thinking goes that in a bad economy people won't give up their electricity or phone service. Not surprisingly, we found that the majority of market participants found comfort in flocking to these same sectors in the face of the economic crisis a year ago. In our judgment, there was little opportunity there. In fact, we believed owning these businesses could be a very risky proposition instead of a safe one because investing in line with consensus has historically proved to be financially punishing.

Likewise, we saw little opportunity in businesses that required the economy to grow in order to experience growth themselves. There are countless businesses like this in the world. Examples include big auto manufacturers, most big leisure companies, and the majority of the large transportation companies. Our belief was, and still is, that the global economy may be sluggish for longer than people expect or hope, and therefore, businesses that require the economy to drive their growth may not be good investments.

With the knowledge that we did not want to own the obvious survivors or the purely economically-sensitive businesses, our focus turned to the non-obvious survivors which could grow irrespective of what happened in the economy (within a band of reason). Once found, we weeded through these businesses to determine which ones we believed we had a proprietary view on. Said another way, we looked for businesses that we thought could double in size over a period of five to seven years, where we were not being asked to pay for that growth in earnings power today. Examples of such types of businesses include International Rectifier Corp. (which we wrote about in our 2008 annual letter and will follow up on), TravelSky Technology Ltd., and AMN Healthcare Services Inc.

International Rectifier Corp. (IRF) is a semi-conductor company but we see it as a company that could help reduce the world's dependence on carbon fuels. While studying the business, we learned that approximately 40% of the world's carbon fuels are used to create electricity and much of this electricity is used to power small electric engines in our homes such as the ones in our refrigerators, washers, dryers, air conditioners, and dishwashers, to name a few. The issue with these engines is that most operate with one-speed motors which are energy inefficient. IRF is a pioneer and world leader in advanced power-management technologies that allow for the creation of variable speed motors. We started to get excited when we thought of all the appliances in the world that could go from one-speed to variable-speed motors and the type of revenue opportunity this would mean for IRF.

A second big idea that we saw in IRF was a power-device platform called gallium nitride (GaN). Most appliances lose heat as electricity runs through them. Think about how hot your lap gets when you sit for a long time with a laptop on it. This heat is not energy that is used in the laptop but energy that is lost in the transmission of electricity through the laptop. In a world facing an energy shortage, wouldn't it be nice to come up with a technology that allowed for less waste? That is exactly what GaN provides. GaN allows for 10 to 20 times lower resistance to electric current than to silicon, which is the primary material used in semiconductors today. This means GaN reduces the power lost to heat. Not only does this increase the energy efficiency for appliances that use electricity like computers, but it also means those appliances can be made smaller and less expensively. Why? Because over time, it's possible that appliances such as laptops and desktops could be manufactured without fans inside of them. Since there won't be nearly as much heat loss, there won't be a need for a fan to blow that heat away from all the important components inside the computers.

A year ago, we asked ourselves the question, "Could IRF grow irrespective of what the world's economies did over the next five years (within a band of reason)?" Our answer was yes. Even if the global economy remained sluggish for five years, more and more appliances would use IRF's technologies that allowed for the creation of variable speed motors and more appliances would also use GaN.

The second important question we had to ask ourselves was "Are we being asked to pay for these ideas today?" The answer to this question, in our judgment, was no. Frankly, it was very easy to determine that answer because IRF had $10 per share in cash in the bank with no debt and the stock price was $9. The market was asking us to buy $10 bills for $9, yet get all the upside of variable speed motors and GaN for free. This investment made sense to us and we bought a large position in the company in a very short period of time.

Since our purchase, the shares of IRF have appreciated to approximately $22. At this point, you might be asking yourself, "Why is it still in my portfolio considering the price has more than doubled in less than a year?" The answer lies in what we believe IRF is actually worth, as opposed to where it has come from. The media has done a great job of covering just how far the global markets have rebounded from their March 2009 lows, however, very few of these stories actually reflect on whether what was going on in March of 2009 made any sense whatsoever. To make this point, let's consider an example. Suppose that you spent the last 30 years of your life building a business. This business has lots of growth opportunities ahead of it – in fact you think that it could double in size over the next five years. Your business also has large competitive barriers to entry providing it with pricing power and healthy margins. It also has a top-notch management team to guide it through the good times and the bad. Finally, your business has one million dollars in the bank, owns some of the buildings it occupies, and has absolutely no debt. Now imagine that some crazy person came to you last March and offered you $900,000 for the business. In all likelihood, you would have declined this offer (for those that believe this type of offer is attractive, please give us a call as we would like to take a look at your business).

Now fast forward 10 months. It is January 2010, and someone else shows up at your door and offers you $2.2 million for your business. Is this a good offer? Well, $2.2 million is more than double than what was offered to you 10 months earlier but the reality is that last year's valuation has nothing to do with whether $2.2 million accurately reflects the value of your business. Your business is going to deliver cash flows to you over time, and it is these future cash flows that determine what the business is truly worth.

Looking forward three years, we believe IRF could earn well in excess of $2 per share. If we strip out the cash in their business, $2 per share would mean we would be receiving a 15% earnings yield on our investment. That is attractive today, irrespective of where we were able to buy it a year ago. As such, we continue to be happy owners of the business.

TravelSky Technology was another attractive idea that we started buying about a year ago. It is the sole domestic provider of information technology solutions to China's air travel industry. It operates the computer reservation system and inventory control system used by all Chinese airlines, as well as the only automated passenger processing system in use at Chinese airports. TravelSky can best be thought of as a monopoly toll bridge. If you are a passenger flying within China or into China from another country you have to pay TravelSky. They provide the system for airlines to manage their inventory of seats, as well as the system that allows travel agents and on-line travel providers to view what seat inventory is available. They also provide the systems that Chinese agents use to board passengers. Very simply, this is a nice business with big profit margins and very little capital required to run it. As a result of economies, such as China, evolving and more of those country's citizens being able to afford travel, TravelSky has been consistently experiencing growth in bookings. Specifically, passenger throughput within China has grown from approximately 60 million passengers in 2000 to 190 million passengers in 2009 driving revenue growth of over 15% per year.

A year ago, this unique monopoly was trading for approximately 3 Hong Kong dollars (HK$) per share and the company had 1.50 HK$ in cash with no debt, and 0.50 HK$ in earnings power. In other words, we had the chance to pay three times cash flows for a company that had doubled in size twice in the last 10 years, had very exciting future growth prospects, and had a crystal clean balance sheet. For every dollar we invested, we were receiving over a 30% earnings yield and believed that this earnings yield would increase over time. Similar to IRF, we were not sure why the market was presenting us with this opportunity. Perhaps it was because TravelSky was not a pharmaceutical, packaged goods, grocery, or utility company, and as such, people did not want to own it. Regardless of the reason, it was not our concern. The fact that the opportunity was there is what counted. We bought as much as we could as fast as we could. Since that time, TravelSky shares have more than doubled in value to approximately 7.5 HK$. Like IRF, we continue to be happy owners of TravelSky even though the price has doubled because we believe the future cash flows of the business continue to make TravelSky a very attractive investment. Specifically, we believe that three years from now TravelSky could deliver in excess of a 15% earnings yield. There are no other monopolies in the world that we are aware of offering this type of potential return.

Our final example is AMN Healthcare (AMN). I picked AMN as it is an example of a business that built value during the year however its share price lagged as the markets rebounded. AMN is the largest healthcare staffing company in the United States. It is the leader in travel nurse placement as well as temporary physician staffing and physician permanent placement services. As people age, their use of healthcare services increases exponentially. As has been well documented, the baby boomers are just entering a stage in their life where their use of healthcare services will begin its ascent. One of the main issues facing the U.S. healthcare system is the fact that there won't be enough nurses to service the demands placed on the healthcare system as the baby boomers start consuming more healthcare services. AMN is a solution to this problem. Specifically, they find nurses and doctors for hospitals that are in need of them, and in exchange get paid by the hospitals for their services.

During the last ten years (to the end of 2009) AMN's revenue has increased by over 500%, however, in 2009, its revenue declined. The reason for the decline was due to the employment situation in the U.S. Although demand for nurses remained relatively stable, supply increased materially. Nurses that were considering retirement decided to postpone their decision due to concerns about the economy. These nurses might have had a spouse that lost their job, and as such, could not afford to retire. Alternatively, they could have experienced a decline in the value of their retirement nest egg and, as such, needed to work longer to make up for it. The bottom line is that there was lower demand from hospitals for temporary nurses, and AMN's business was negatively impacted in 2009. The stock market did not like this temporary decline in demand and drove AMN's share price to as low $5 from as high as $28 in 2007. We started buying AMN at approximately $9. We bought it all the way down to $5 and back up to slightly above $9 where it sits today. Although its share price has not moved from where we started buying it, we are more excited about AMN today than we were a year ago. A year ago, we thought it represented good value at $9. Since then, AMN has materially increased its market share as many of its weaker competitors have gone out of business. AMN also dramatically improved its balance sheet throughout the year. Finally, it has been the beneficiary of a cost-cutting trend at hospitals. Specifically, hospitals have gone from using multiple placement providers to using one, and AMN has become the obvious choice to be the single-source provider due to its scale and capacity to service the hospitals. AMN is stronger today than it was a year ago, yet the market is asking us to pay the same price for it that we were being asked to pay a year ago. We are happy with this and look forward to the next three to five years as owners of the business.

Part 2 - Changes to the portfolio during the year

We generally sell a stake in a business for one of two reasons. First, our thesis about the business is deemed to be no longer valid. If we can no longer stand behind our thesis on the business, we can no longer stand behind an ownership interest in the business, and the position is sold. Second, there is a constant culling process whereby we continuously strive to upgrade the quality of the portfolio with better ideas. For example, if one of our ideas becomes well recognized and this fact is reflected in the share price of the investment, it is removed in favour of a more attractive opportunity.

In 2009, we sold businesses in the portfolio for both reasons. Both categories are listed below with positions listed under each category:

The Mistakes

1. GameStop Corp. (GME)
   GME is the world's largest video game distributor. Our thesis was that GME would continue to expand its footprint around the world and that its sales per store would continue to grow. The prevailing concern in the marketplace at the time of our purchase was that video games were on the verge of being entirely distributed via the internet. In our judgment, this concern was unfounded considering that the average video game for the current generation of consoles takes over 24 hours to download. Where we think our judgment was off, however, was on pricing power. At the time of investment, we believed that GME would be able to withstand competitive pricing pressure from stores such as Toys "R" Us or Wal-Mart however we became increasingly concerned that this may not be the case. As such, we sold our position, however the impact to portfolio performance was marginal.

2. Moody's Corp. (MCO)
   We wrote about MCO in our third quarter, 2009 commentary and as such, we will not review it again. Although we consider MCO to be a mistake because our original thesis was incorrect, it actually contributed 1.6% to portfolio performance for the year.

The Successes

These businesses appreciated to the point of being no longer as attractive as other ideas in the portfolio:

1. American Express Co.
2. CME Group Inc.
3. DCC Plc.

4. Grupo Modelo S.A. de C.V.
5. HEICO Corp.
6. Misumi Group Inc.
7. Schindler Holding AG
8. WPP Plc.

The proceeds from the sale of these positions were redeployed into existing positions or new positions during the year.

Part 3 – Is it over? Did I miss it?

We have recently been asked a number of times to weigh in on whether the stock market "has run too far, too fast". The world is not short of people that are willing to give their opinions on what is going to happen next week, next month, or next quarter to the stock market. However, in our opinion making short-term forecasts adds no value whatsoever. We believe that the short term is always uncertain. In our judgment, what is more certain is that it is always important to own a collection of businesses that can grow in the future, yet still represent good value today.

It continues to be our view that when it comes to the global economy, things might be tougher for longer than most people hope or expect. Given this, we believe it is important to focus on businesses with strong growth prospects, which are independent of global economic growth. We want to own businesses for what they are doing to themselves instead of what is being done to them. Counting on the economy to make a business a good investment is not as good as finding a business that can grow irrespective of what happens in the economy (within a band of reason).

Today, optimism and pessimism in the market place appear to be in balance. This is a relatively unique situation as usually either fear or greed has an edge in the market. What is beneficial about this "balanced situation" in our judgment is that the market is offering up opportunities to buy growth companies without paying for that growth today. We have spoken about such situations in this commentary (i.e. IRF, TravelSky, and AMN). These three names are not unique. We have attempted to build an entire portfolio of companies with a similar blend of growth and value. As such, looking forward, we are encouraged by the prospects facing the businesses in your portfolio. In the short term, there will continue to be volatility in the market place, and the valuation of businesses will rise and fall with this volatility. Longer term, however, we believe the portfolio is comprised of a sound collection of ideas.

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.

In summary, we are attempting to approach investing in these turbulent markets with a sense of measured confidence. We will not deviate from EdgePoint's deceptively simple investment approach. We will continue to invest behind our convictions. We will remain focused on our goal of building wealth for you over the long term, and we will make every effort to keep our emotions within a narrow emotional band.

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

Sincerely,

Tye Bousada