

Written by Tye Bousada

Thank you “New Normalists”

A good time to invest can occur when failure is taken for granted. The year 2010 seemed to be such a year. The dominant theme was the “New Normal”, which is a fancy catch-all slogan to describe the pessimists’ view that hope is dead.

In the face of this large wave of negative macro sentiment, we remained firmly focused on our competitive strengths. 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 this as a backdrop, we’ve broken up this year’s commentary into four sections.

- 1. New Normal Risks**
- 2. Opportunities Created by the New Normalists**
- 3. Looking Forward – Growth for Free**
- 4. Looking Forward – Volatility?**

Part 1 – New Normal Risks

A decade ago, the investment mantra was “growth at any price”. Five years ago, it was all about leverage. In 2010, the mantra was the New Normal. Type this into Google and you get 330 million hits. There were 47,600 references to the New Normal in the media during the past four weeks alone according to Google. Even the President of the United States could not resist using the term during a 60 Minutes interview in November when he said he feared the U.S. economy could enter a New Normal.

What exactly is the New Normal? Our best guess is that it is a term used to describe a collection of macro fears which include high unemployment levels, household deleveraging, sovereign debt risks, austerity measures, the battle between the dual evils of inflation and deflation, and any other number of macro investment-related fears grabbing headlines today. The New Normalists would like you to believe that the huge quantity of economic problems facing the world precludes an intelligent solution to any one of them. In short, they would like you to believe that hope is dead.

Like all popular investment mantras, this one has ushered in an entirely new set of investment risks and opportunities. From a risk perspective, the macro fears underlying this argument led to a massive rush into investments labelled as “safe”. With little hope for the future, cash and bonds became popular “safe” investments. Regrettably, what seemed to be forgotten by the average investor is that safety is entirely a function of the price that is paid. At the wrong price, a perceived “safe” investment can be the riskiest thing to own. Let’s walk through a few quick examples.

How can cash be a risky investment?

Cash has historically proven to be the absolute worst investment over any meaningful time period. Each year, the value of cash declines by the rate of inflation minus the nominal amount of interest. Let's suppose inflation is 3% per year for the next decade and you earn a 1% return on cash. Your annual return is therefore -2%. By simply owning cash, you will be 22% poorer 10 years from now.

How can fixed income be a risky investment?

Fixed income is another good example of where large pockets of risk were masqueraded as safety in 2010. The unquenchable demand for yield led some investors to put themselves at high risk for permanent loss of capital. In today's environment, for example, there are many investors who are looking for a "guaranteed" 6% return from their fixed income investments. These investors don't want to take on any risk, and as such, are willing to accept only 6% from fixed income. Unfortunately, there is no such thing as a risk-free 6% in the fixed-income world today. To pick one example, let's consider a 100-year Mexican bond that was issued in the second half of 2010. In exchange for lending money to Mexico and taking on the risk that the country will not repay your principal in a century, the average investor was willing to accept 6.1% annually. Mexico is a country that has defaulted four times on its obligations during the last two centuries. Does 6.1% truly compensate the investor for the risk of at least one more default in the next 100 years, never mind the risk of inflation rising at some point in the upcoming century? We don't believe this is adequate compensation. Rather, we believe that this is an example of a risk for permanent loss of capital created by New Normal thinking.

Part 2 - Opportunities Created by the New Normalists

Most popular investment mantras come with their fair share of risks however, they also create opportunities. As a result of the large amount of macro-economic fears, many investors perceived equities as being too risky. It was this high level of fear about equity ownership that has, and continues to present us with, the opportunity to buy growth for free. These comments should not be interpreted as us "cheerleading for the stock market". As we have said in the past, we believe the economy could be slower for longer than most people expect, which means limited upside for the stock market. However, during periods of indiscriminate selling by the New Normalists, businesses that are able to grow through economic malaise are thrown out with the vast majority of businesses that can't. It's our job to find these mispriced opportunities.

One example of this is Interface Inc. Interface is the world's largest global manufacturer of modular carpet (i.e. carpet tiles used in offices, schools, hotels, etc). Interface invented modular carpet back in the 1970's. The primary value proposition of modular carpet is that certain areas of a carpet experience more wear and tear than other areas, and as such, need to be replaced more often. With regular carpet, even if only 20% of it is showing wear and tear, the entire carpet needs to be replaced, making it very uneconomical. With carpet tile, only the portions showing wear and tear need to be replaced. Due to this value proposition, carpet tile has increased from a 0% market share of U.S. commercial installations to approximately 34% today. In markets outside of the U.S., penetration rates vary from 8% in Germany to 44% in the United Kingdom and Ireland, with an average penetration rate of approximately 30%.

Interface's share price declined drastically as investors believed that few people would buy modular carpet in the future. After carefully studying Interface's opportunities, we saw a very different future. Specifically, we

saw an opportunity for Interface to increase its market share of commercial carpet from 30% to approximately 50% (the company believes it can achieve 65%). The bottom line was that we could realistically see Interface generating approximately \$1 per share in earnings with an average share price of approximately \$5. Looking at this math in a different way, we felt that even if the economy remained tough, we could, in a reasonable amount of time, earn \$1 per year on a \$5 investment. This was obviously attractive and we bought as much as we could as quickly as we could.

In a short amount of time, Interface demonstrated that, despite a sluggish global economy, it could grow quickly. During the first three quarters of 2010, Interface's revenue and earnings grew by 11% and 367% respectively. Even with an enormous amount of pessimism surrounding equity investments, we don't believe that the market can indefinitely ignore strong and growing companies and we felt Interface's true value would eventually be recognized. This occurred as Interface's profitability began to balloon. Its share price increased to \$14 (from our average cost of \$5 and our initial purchase price of \$2), and we sold our stake in the company. This price appreciation made Interface one of the largest contributors to portfolio performance in 2010, and we have the New Normalists to thank for the opportunity.

Part 3 - Looking forward - Growth for Free

At the end of the year, the portfolio was comprised of 31 businesses that are in a unique position to grow their value in the face of a sluggish economy. Importantly, due to the negative sentiment about the future, the growth potential of these companies is not currently reflected in their stock prices.

We'll illustrate this by looking at the free cash flow of a business. This metric measures what is left over for the owner of a business after all expenses have been paid. The owner's return is then calculated by dividing the company's free cash flow by the price paid for the business. Imagine you bought a business that makes chewing gum and it cost you \$100. In the first year, your revenues were \$20 and your expenses to operate the business were \$15. Applying this math, you achieved a return on your investment of 5% (\$20 less \$15 divided by your \$100 original investment).

The ten largest holdings in your portfolio at the end of the year made up approximately 50% of the entire portfolio. The average free cash flow yield (or owner's return) of those ten companies was approximately 9% at the end of December 2010. This figure doesn't assume any improvements in revenues or expenses going forward. Additionally, most of these businesses have excess capacity, which means their near-term growth in revenues can be supported by little to no increase in expenses.

Free cash flow can be used to buy back shares. Click [here](#) to learn why this can be so powerful.

Now ask yourself this important question: If your investment horizon is five years or longer, what would you rather own?

- A. Cash which is earning 1% annually and will lose purchasing power with inflation
- B. A 10-year Government of Canada bond which pays 3.1% annually with no chance for growth
- C. A 100-year Mexican bond which pays 6.1% annually with no chance for growth
- D. A portfolio of growing businesses which are currently providing a 9% return on investment before accounting for any growth

We believe the best answer is D.

Interestingly, since the late 1960's, the free cash flow yields of companies have closely resembled the rates of returns available on government bonds. It is only within the last couple of years that free cash flow yields of businesses have decoupled from the government bond yields. We believe this anomaly is due to the New Normal pessimism in the market. Although, this is cause for optimism, what makes us particularly optimistic is that we believe the businesses in your portfolio will grow in the face of a tough economy. Any growth in these businesses only adds to your returns. Today, we believe the market is giving away this growth for free, but if history is a guide, the market will eventually pay for it as fear recedes and greed takes over.

Part 4 - Looking forward – Volatility?

In summary, we are attempting to approach investing in these turbulent markets with a sense of measured confidence. The cloud of pessimism that is hanging over the global capital markets is large, creating what we believe are select opportunities to build material wealth in the future.

It will not be a straight shot upwards from here for the share prices of your businesses. Since the inception of your portfolio in 2008, returns have been pleasing in both absolute and relative terms; however, the path has been bumpy. In order to add value over the long term, sometimes you have to look wrong in the short term. Interface is a good example of this. Some other examples include:

1. BorgWarner Inc. – auto parts manufacturer based in the United States

We originally purchased BorgWarner in the fall of 2008 when the consensus view was that few cars would be sold again due to the poor state of the economy. When rational thinking prevailed and investors realized that new cars would still be in demand, we sold our shares in this company at the beginning of 2010 at a price that was over 100% above our initial purchase price.

2. Makita Corp. - power tool manufacturer based in Japan

We originally purchased Makita in January of 2009 on concerns about a decline in construction in Europe (Makita's largest export market) which weighed on the share price. As construction in Europe slowly rebounded, Makita's share price rebounded as well and we sold our position in 2010 at a price that was 90% above our initial purchase price.

Looking forward, we can guarantee that the path will continue to be volatile. Today's New Normalists will find something different to focus on tomorrow – we'll call it "The New New Normal". The New New Normal will again adopt a macro obsession and trade with an utter disregard for business fundamentals. It will be our job to take advantage of the situation and add value by capitalizing on the fear and greed presented by the New New Normal.

The bottom line is that the only thing that is normal and predictable about the stock market is volatility. We have and will continue to embrace volatility as, historically, it has allowed us to add value for you.

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

Fixed Income Comments

Written by Frank Mullen

While government balance sheets continue to look troubled, many corporations improved their balance sheets in 2010 by refinancing their debt and building large cash balances. At a time when we felt that government bond yields were not adequately compensating investors for their inherent risk, we found the opportunities in the corporate bond market to be much more favourable. We identified many strong companies, with proven track records of consistently generating cash, which offer yields that were much greater than those of their government counterparts of similar maturity. The risk-reward scenario in the corporate bond market was particularly compelling as we entered 2010.

As the year progressed, and corporations proved that they had the ability to survive the current economic environment and position themselves favourably for the future, our investments in corporate bonds proved rewarding. We continue to believe that the additional yield provided by corporate bonds is compensating investors for the associated risks. As a result, the fixed-income component of the portfolio remains fully invested in corporate bonds.

With government bond yields at all-time lows, we are acutely aware of the interest rate risk in our fixed-income investments. While we don't know when interest rates will begin to rise, we don't want to be overly exposed when they do. As fixed-income managers, we use the portfolio's duration as a measure of interest rate risk. In a rising interest rate environment, a portfolio with a high duration has greater interest rate risk than a portfolio with low duration. Our fixed-income portfolio had a relatively low duration throughout 2010. Currently our portfolio has half of the amount of interest rate risk than that of the Canadian fixed-income index (DEX Universe Bond Index). This did not serve us well in 2010 as interest rates continued to trend lower; however, we were still able to outperform the index due to our corporate bond exposure and ability to select good investments by applying rigorous credit analysis. We continue to believe that approaching the fixed-income investments with a defensive duration stance is prudent.

Calfrac Well Services Ltd.

We were quite optimistic about the future of Calfrac and owned both their debt and equity securities in most of 2010. We participated in a re-opening of their 7.75% debt issue in December 2009 at a purchase price of \$94.50. Due to favourable credit market conditions, the company decided to refinance this debt and extend the maturity. They repurchased the bonds from us at over \$105.50 just one year later resulting in a holding period return of approximately 20%. Although we still felt strongly about the prospects of Calfrac's underlying business, we did not participate in the re-financing as we didn't believe the yield properly compensated for the additional interest rate risk.

As we look forward to 2011, there are several signs that concern us:

- Absolute yield levels on investment grade new issuances are at all-time lows (i.e. Walmart, IBM, McDonald's)
- Credit spreads for certain sovereign debt, investment grade and high-yield issuers are not representative of the associated credit risk

- Bond agreements are becoming less restrictive for borrowers with looser capital allocation policies, enabling them to take on greater amounts of leverage
- After 99 straight weeks of inflows in the U.S. (as at November, 17, 2010), bond funds have suffered from several weeks of net redemptions. The week ending Dec. 15, 2010 showed the largest outflows since November 2008 when investors were liquidating due to the credit crisis. Will an outflow from bond funds affect prices in the bond market?

The above points are indicative of investors focusing on return potential, with less regard for risk. Our number one priority at EdgePoint is the preservation of capital by focusing first on the inherent risk of an investment and then analyzing the potential return.

Commentary as at December 31, 2010. The above companies are selected for illustrative purposes and are not intended to provide investment advice. EdgePoint Investment Group Inc. may be buying or selling positions in the above securities.

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