CYMBRIA

Still the same old investment approach

By Tye Bousada, portfolio manager

My youngest son had some friends over the other day. During dinner, the conversation turned to what I did as a profession. I explained that I was an investor in businesses. Then they asked how I make my decisions. In response, I walked them through a quick mental exercise that I think is worthwhile sharing with you, as it gets to the heart of how we try to protect and grow the money you have entrusted us with. Here's the mental exercise:

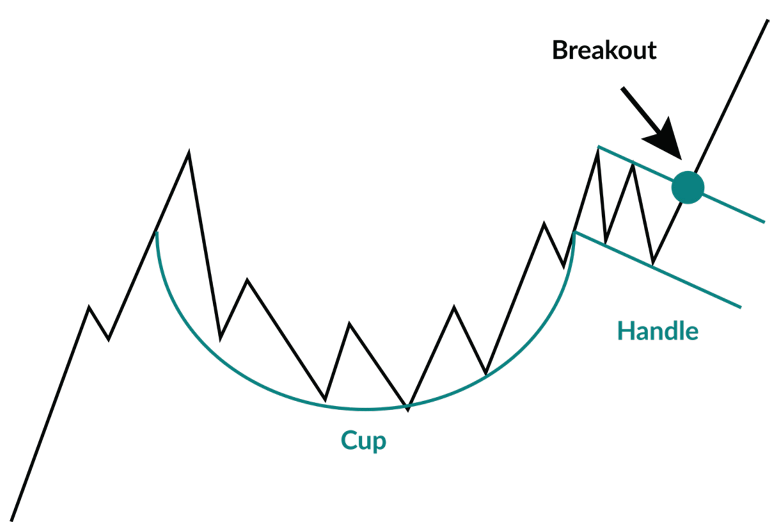
Imagine you have $500,000 to feed, shelter and clothe your family for the next 30 years. You need to invest this money to protect your family against inflation. Now imagine that I show up on your doorstep and say, "I have a business to sell you, and the price that I put on that business is $500,000." You reply, "As it turns out, I have that sum to invest, so tell me about your business." I respond, "The only thing I'll tell you is that next quarter's profits will be bigger than this quarter's profits. You don't need to know anything else. The quality of the business doesn't matter, its long-term growth prospects don't matter, profit margins don't matter and management doesn't matter. You don't even need to know the name of the business. All that matters is that profits in three months will be higher than profits today. Give me your money!"

Would you invest the money that is intended to feed, shelter and clothe your family for the next 30 years?

I'm going to guess that almost every single person reading this is thinking at this point, "Of course I wouldn't invest in your business." In fact, my son's friends laughed at me when I asked them if they would invest and they're only 14 years old. However, they stopped laughing when I explained that billions of dollars every single day change hands in the stock market based on this investment approach. The approach is called momentum investing.

Momentum investing: a trading strategy that relies on a stock's price movement to continue in the same direction. This means buying assets with increasing prices and selling those that are decreasing.

Imagine now that I show up on your doorstep and say I have a different business to sell you, and that the price is $500,000. I'm not willing to tell you what the company does, how it's managed, what its opportunities for growth are, or what its profitability is like. Instead, I show you a piece of paper with the following lines on it:



Source: "13 Stock Chart Patterns That You Can't Afford to Forget", optionalpha.com,https://optionalpha.com/13-stock-chart-patterns-that-you-cant-afford-to-forget-10585.html

I explain that the company's share price is going through a classical "Cup and Handle" pattern and, because of this, you should give me your money and I should sell you my business.

Would you give me your money in exchange for my business? I hope not. But would it surprise you to know billions of dollars every day exchange hands in the stock market based on this investment approach? It's called technical analysis.

Technical analysis: a trading strategy that evaluates investments and trading opportunities based on a stock's historical trading activity such as price movement and volume.

Finally, imagine that I show up on your doorstep and say that I want to sell you my business for $500,000. All you need to know is that a bunch of PhDs have analyzed the business' historical share price movements and, based on running some very complicated math through some super-expensive computers, these PhDs believe its price will be higher in three months' time. To try and convince you that these PhDs know what they're doing, I show you some of their math that looks like this:

- $\Phi_{RR_T|N=T}(s) = \mathrm{E}\left[e^{\left\{i\left[\sum_{t=1}^{T} R_t \times I_{\{B_{t-1}\geq 0\}}\right]s\right\}}|N = T\right]$
- $= \mathrm{E}\left[e^{\left\{i\left[\sum_{t=1}^{T} R_t \times I_{\{B_{t-1}\geq 0\}}\right]s\right\}}|B_T < 0, B_{T-1} \geq 0, \ldots, B_0 \geq 0\right]$
- $= \mathrm{E}\left[e^{\left\{i\left[\sum_{t=1}^{T} R_t\right]s\right\}}|Z_T = 0, Z_{T-1} = 1, \ldots, Z_1 = 1\right]$
- $= \mathrm{E}\left[e^{\{i[\varepsilon_1 + \cdots + \varepsilon_{T-1} - \delta_T]s\}}\right]$
- $= \begin{cases} {\Phi_\varepsilon}^{T-1}(s)\Phi_\delta(-s), \ \mathrm{T} \geq 1 \\ \Phi_\delta(-s), \ \mathrm{T} = 0 \end{cases}$

Source: Li, Haksun, "Quantitative Trading as a Mathematical Science", https://www.slideshare.net/Quantopian/quantitative-trading-as-a-mathematical-science-by-dr-haksun-li-founder-and-ceo-numerical-method-inc

Would you give me the money that's intended to feed, shelter and clothe your family for years to come? I'm going to guess that you wouldn't. But once again, would it surprise you to know that billions of dollars a day trade in the markets based on this approach? It's called quantitative analysis.

Quantitative analysis: a trading strategy that evaluates investments based on mathematical and statistical modeling, measurement and research.

When we walk through examples like the ones above, most people strongly believe that they wouldn't feel comfortable investing their family's future using similar approaches. The unfortunate truth, however, is that hundreds of billions of dollars earmarked for feeding, sheltering and clothing people's families are guided by these approaches. Somehow, though, when this money is invested in the stock market, people can lose sight of how their futures are being invested.

The most important point about walking through these examples is to highlight that what you would do if you were asked to engage your family's future in one business is what we do, every single day, at EdgePoint.

You would first start by wanting to gain a fundamental understanding of what the company does and who it competes against. You would want to see lots of growth in the future and competitive barriers to entry around the business that will serve to protect the company's profitability. You would want good management in place and to see a succession plan that is well thought out. And finally, you would want all of these good things but you would want them at the right price. While there are many good businesses in the stock market with characteristics like those just mentioned, the market often asks you to pay two to three times what the business is truly worth. Would you invest your family's future in a business overvalued by 200% to 300%? It's a rhetorical question. Obviously, you wouldn't. You would want all these nice things but you wouldn't want to pay full value for them. That way, you would get some or all of the future growth in the business without paying for it. We are the same.

We're long-term investors in businesses. We view a stock as an ownership interest in a company and endeavour to acquire these ownership stakes at prices below our assessment of their true worth.

We believe that the best way to buy a business at an attractive price is to have an idea about the business that isn't widely shared by others – what we refer to as a proprietary insight.

We strive to develop proprietary insights around businesses we understand. This means we try to figure out how a business is going to become bigger in the future and if we are getting some or all of this future growth for free at the current share price. We focus on companies that have strong competitive positions, defendable barriers to entry and long-term growth prospects and are run by competent management teams. These holdings generally reflect our views looking out beyond five years. We firmly believe that focusing on longer periods enables us to develop proprietary views that aren't reflected in the current stock price.

Our approach is deceptively simple. We buy good, undervalued businesses and hold them until the market fully recognizes their potential. Following this approach requires an ability to think independently, a natural curiosity necessary to search out new ideas and a commitment to embrace the thorough research required to uncover opportunities the market doesn't fully appreciate.

We approach each business as though it's the business that's going to feed, shelter and clothe our own family. You might say this is easy to say but tougher to prove, but at EdgePoint it's very easy to prove because the internal partners at EdgePoint (EdgePoint employees) collectively hold $262 million[i] in company-related products – the same products you own. As such, when we buy a business for one of those portfolios it's literally tasked with feeding, sheltering and clothing our families.

It becomes easier to believe in an investment approach after it delivers pleasing long-term returns. The returns become linked to the approach and it becomes more difficult to decipher whether you believe in the historical returns or truly understand and believe in the approach. Although we are pleased with our historical returns, we treat them as just that – history. We believe that, in order to maximize your outcome with EdgePoint going forward, you must fundamentally believe in how we are investing your money.

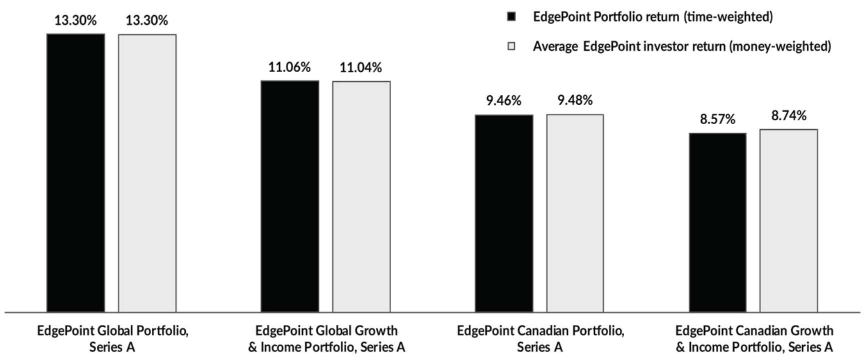
Why do you have to understand our approach if we are the ones ultimately using the approach to invest your money? There are multiple reasons, but let's deal with the two most important ones.

First, the stock market seems to swing between moments of euphoria and dread. When it swings down, if you don't believe in how your money is being managed, you won't be able to stay invested, which destroys your ability to achieve positive outcomes in the long term. If you look at our long-term returns, the investors who actually achieved those returns were the ones who stayed invested during periods of panic. Staying invested is very hard to do for the average investor. In fact, a good proportion of investors don't have that kind of discipline and commitment.

We've put a large effort into only partnering with financial advisors who understand how we manage money and who strive to ensure that their clients (you) understand the EdgePoint investment approach before they invest. The outcome of these efforts is best exemplified by the chart below, which shows that the average investor in the EdgePoint Portfolios actually achieves the returns of the underlying portfolio.

Ten-year annualized returns by Portfolio

Jun. 30, 2009 to Jun. 30, 2019



Source, EdgePoint Portfolio returns: Fundata Canada, net of fees. Source, average EdgePoint investor returns: CIBC Mellon. As at June 30, 2019. All returns annualized and in C$. Average EdgePoint investor returns are the average money-weighted returns net of fees across investors who held EdgePoint Portfolios, Series A from June 30, 2009 to June 30, 2019. EdgePoint Portfolio returns are time-weighted to best reflect the manager's performance based on compound growth rate, which isn't impacted by portfolio cash flows. Money-weighted average investor return takes into account the investor's decision(s) regarding the timing and magnitude of cash flows and represents their personal rate of return. See below for important disclosures regarding EdgePoint Portfolio and benchmark returns.

During times when the market dropped over the last 10 years, our investors, with the help of their financial advisors, didn't panic. They (you) stayed invested because they understood how their (your) money was being managed. They (you) treated our investment approach like a port in a storm. In fact, in many cases our investors not only stayed the course, but also added to their existing positions, which helped them outperform the underlying portfolio.

The second reason it's important to understand our investment approach is because sometimes we have to look wrong in the short term to be right in the long term. You cannot materially outperform a benchmark by looking like a benchmark. Since the inception of our firm, there have been five periods when we underperformed over the short term. In spite of these five periods, our long-term results have been pleasing on both an absolute and relative basis. Sticking to our investment approach during these periods was critical to achieving these results.

Looking forward, your belief in the approach will surely be tested again. If history is a guide, it will coincide with a period of time when majority of investors start believing that the rules of investing have changed. Or, said another way, that "this time is different."

This time is different

During the last 10 years, examples of "this time is different" thinking in the stock market have included: the "Great Recession"; the European sovereign debt crisis; the U.S. debt downgrade; and the emerging market slowdown of 2015/16, just to name a few.

More recently, the "this time is different" mentality seems to have crept into the market again. Specifically, belief is growing that government deficits can grow exponentially without becoming problematic, that we can have economic strength forever without inflation and, finally, that interest rates won't materially increase again.

Belief in ideas like this causes "weird" things to happen in the market.

For example, if you believe that interest rates will stay low forever then you might question the idea of "time value of money". Time value of money states that a dollar is worth more in the present than the same amount in the future. In other words, a dollar today is worth more than a dollar tomorrow. The idea behind this concept is that if you have to wait to receive your funds, you're missing out on other potential investment opportunities. If you have to wait, you'd expect some compensation for waiting. The most common type of compensation is interest.

However, if you believe interest rates are going to be very low forever, you suddenly become indifferent between a dollar today and a dollar tomorrow. When you become indifferent, companies that don't make profits today, but hope to make profits at some distant point in the future, suddenly become relatively much more attractive to you – because you are indifferent between getting money today or in the future.

This scenario has started to take hold in the stock market.

The following 10 companies lost US $4.5 billion pre-tax last year and have no near-term expectations of making a profit. The stock market has assigned a collective value of US$187 billion to them[ii].

- Beyond Meat, Inc.
- Chewy, Inc.
- CrowdStrike, Inc.
- Fiverr International Ltd.
- Lyft, Inc.
- PagerDuty, Inc.
- Pintrest, Inc.
- Slack Technologies, Inc.
- Uber Technologies, Inc.
- Zoom Video Communications, Inc.

Imagine you had $500,000 to invest in a business and I showed up on your doorstep with a business to sell you. I tell you the business makes no money today and actually loses a lot every single day, but the company is growing quickly. I further explain that the business doesn't have a prospect of making money for at least five years and the annual losses will have to be funded by you for that period of time. However, if the business can continue to grow rapidly and the competitive environment doesn't change, then at some point, "maybe" in the sixth year, the business could be profitable. Would you give me the money that's intended to take care of your family in exchange for my business? I'm guessing probably not. We don't invest in these types of ideas either.

Our approach has historically helped us avoid "this time is different" types of situations.

However, the point is it's very possible that the collection of businesses above could proceed to double in value over the next 12 months. More and more people might believe that the time value of money idea is broken and that a dollar in the future is worth just as much as a dollar today. In that environment, we might underperform. Your confidence in staying the course with your EdgePoint investment will be determined by your understanding and appreciation of our approach.

As in the past, you will have to understand that it's not what we don't own that dictates your long-term returns, but instead it's what we own that does. You will need to believe that we have assembled a collection of businesses where we are getting some or all of their future growth for free on your behalf. It won't be easy but, if history is a guide, it should be profitable.

In conclusion, the most valuable thing about EdgePoint is the application of our investment approach. Our most important goal, however, is making money for you. These two most important things are linked: we have a better chance of delivering pleasing returns for you over the long term if you understand and believe in the Cymbria investment approach.

Learn more about our approach:

- The EdgePoint way to invest
- Commentaries
- Cymbria Day videos (Investment Portions)
- EdgePoint Academy
- Inside Edge*

We continue to approach investing with measured confidence, value your trust in us and look forward to working to build your wealth in an effort to be worthy of that trust.

* Inside Edge is our Investment team's curated briefing of our latest reads and daily musings. It was originally a way to share good reading among our internal partners, but we thought our external partners would also enjoy a glimpse into what we're reading, helping them become better informed investors. While most posts are investment related, you'll also find shareable investor-friendly materials and looks into the lives of EdgePointers.

Performance as at June 30, 2019 Annualized, total returns, net of fees, in C$.	YTD	1-year	3-year	5-year	10-year	Since inception*
EdgePoint Global Portfolio, Series A	11.27%	1.33%	13.79%	12.40%	13.30%	15.33%
MSCI World Index	11.92%	5.63%	12.00%	11.05%	12.03%	12.07%
EdgePoint Canadian Portfolio, Series A	14.58%	-2.05%	6.41%	4.46%	9.46%	11.44%
S&P/TSX Composite Index	16.22%	3.88%	8.40%	4.67%	7.79%	9.26%
EdgePoint Global Growth & Income Portfolio , Series A	8.18%	2.27%	10.54%	9.53%	11.06%	12.51%
60% MSCI World Index/40% ICE BofAML Canada Broad Market Index	9.91%	6.56%	8.30%	8.27%	9.14%	9.32%
EdgePoint Canadian Growth & Income Portfolio, Series A	10.88%	0.23%	6.16%	4.60%	8.57%	9.92%
60% S&P/TSX Composite Index/40% ICE BofAML Canada Broad Market Index	12.43%	5.51%	6.19%	4.49%	6.66%	7.70%

* November 17, 2008.

Source, index returns: Morningstar Direct. Returns are annualized, total returns, net of fees, in C$. As at June 30, 2019.

The MSCI World Index is a broad-based, market-capitalization-weighted index comprising equity securities available in developed markets globally. The index was chosen for being a widely used benchmark of the global equity market.

The S&P/TSX Composite Index is a market-capitalization-weighted index comprising the largest and most widely held stocks traded on the Toronto Stock Exchange. The index was chosen for being a widely used benchmark of the Canadian equity market.

The 60% MSCI World Index/40% ICE BofAML Canada Broad Market Index. MSCI World Index is a market-capitalization-weighted index comprising equity securities available in developed markets globally. The ICE BofAML Canada Broad Market Index tracks the performance of publicly traded investment grade debt denominated in Canadian dollars and issued in the Canadian domestic market. The blended benchmark was chosen because MSCI World is a widely used benchmark for the global equity market and the ICE BofAML Canada Broad Market Index ae representative of fixed-income opportunities consistent with the Portfolio's mandate.

The 60% S&P/TSX Composite Index/40% ICE BofAML Canada Broad Market Index. The ICE BofAML Canada Broad Market Index tracks the performance of publicly traded investment-grade debt denominated in Canadian dollars and issued in the Canadian domestic market. The blended benchmark was chosen because the S&P/TSX Composite is a widely used benchmark of the Canadian equity market and the ICE BofAML Canada Broad Market Index are representative of fixed-income opportunities consistent with the Portfolio's mandate.

We manage our Portfolios independently of the indexes we use as long-term performance comparisons. Differences including security holdings and geographic/sector allocations may impact comparability and could result in periods when our performance differs materially from the index. Additional factors such as credit quality, issuer type and yield may impact fixed-income comparability.

[i] As at December 31, 2018.

[ii] Source: FactSet Research Systems Inc. Earnings before interest & taxes (EBIT) during calendar year 2018 were used to measure the collective loss. EBIT is a measure of a firm's operating profit before interest expenses and taxes. The total market capitalization was used to measure the collective value of the businesses as at June 26, 2019.

Published July 5, 2019.