CYMBRIA®

INVESTMENT COMMENTARY For the quarter ending March 31, 2020

We understand the gravity of our responsibility to you

By Tye Bousada, portfolio manager

Dear fellow investors,

We understand that the last few weeks have been extremely trying. The virus has created a difficult situation for the whole world and the uncertainty has caused significant declines in global stock markets. This has caused losses in your Portfolio. Although we deem the declines to be temporary in nature, we understand that drawdowns like this are difficult to experience. We understand the gravity of our responsibility to you, and we have not wavered from our goal of helping you achieve your long-term financial objectives. Furthermore, we stand shoulder-to-shoulder with you – the internal EdgePoint partners are collectively the second largest owner of company-related portfolios..

Let us start by saying that in our entire careers, we have rarely seen an opportunity to add as much long-term value for our investors as we do right now. This isn't to say that we believe that things will start getting better tomorrow, as we have no idea how this situation is going to play out over the next few weeks or months. But we do believe that the long term is what really matters in investing, and our confidence level is much higher for the longer term.

With that as a backdrop, here are seven things we know to be true even in today's very uncertain environment:

1. **We know that the underlying value of a business doesn't change by the second.** The stock market seems to make people believe the opposite. You own a collection of actual businesses in your Portfolio, not just pieces of paper whose value fluctuates wildly by the second. The value of the actual businesses you own is determined by the sum of the future profits these businesses will deliver over the very long term. Even a material impact to their short-term profits (say, next year's profits) shouldn't affect the underlying value of your businesses significantly over the long term provided that they're able to meet their short-term obligations.

As an example, let's assume you just bought a business for $1.5 million, and that business produces $100,000 a year in earnings. In other words, you paid 15 times earnings for the business. Let's assume the $100,000 in earnings each year is a good proxy for the money you can take out of the business as a dividend. Let's also assume you plan to own the business for 20 years and then sell it in the twentieth year so you can retire.

Assuming no growth

If for some reason the business doesn't grow over the next 20 years and instead continues to earn the same $100,000 every year, you would put $2 million in your pocket over the 20 years as an owner of the business ($100,000 in earnings each year, times 20 years). And if you sold the business for the same 15 times earnings multiple that you bought it for, you'd also receive $1.5 million in proceeds 20 years from now. In total, you would receive $2 million plus $1.5 million (for a total of $3.5 million) for the business that initially cost you $1.5 million 20 years prior.

But what if something happened in the first year and your business experienced zero profit for that year? You'd receive $100,000/year for the following 19 years instead of 20 years, or $1.9 million. Assuming that the company is still valued at 15 times earnings in the 20th year, you'd receive $3.4 million over 20 years instead of $3.5 million (2.9% less over the entire period). Even a material impact to the short-term profits of your business – like earning no profits for an entire year – didn't materially impact the value you received as an owner of the business in the long term.

Of course, this example ignores the time value of money, meaning that a dollar in 20 years isn't worth as much as a dollar today. The value of a dollar depreciates each year by the rate of inflation. If we assume a 3% inflation rate, then we can discount back these proceeds at 3%. Doing this makes a dollar in the future equal to a dollar today. Using this calculation, the future dollars received from the dividends and the sale of the company, discounted to today's dollars, would be worth $2.3 million. And if you had zero profits in the first year, then the sum of proceeds in today's dollars would be $2.2 million. Wiping earnings to zero in the first year would reduce the value you receive as an owner by 4% in today's dollars. That's not a big difference in the grand scheme of things, especially when we consider, in this example, that the business didn't grow over the 20 years.

Assuming growth

If you could grow the company's earnings by 8% per year, then the dividends received over 20 years, plus the value of the business in year 20, would be worth $6.7 million in today's dollars. Having earnings drop to zero in the first year would cause that number to drop to $6.6 million, so the difference would be only 1%. Sure, it would have been painful to see profits get wiped to zero immediately after buying the business, but would one year have a material impact on its long-term value? We think 1% is pretty small in the grand scheme of things. The market tends to overreact when short-term profits are impacted, but the math here highlights that an overreaction can often be just that, an overreaction.

This is an overly simplistic example, AND IGNORES SUCH THINGS AS TAXES AND COST OF CAPITAL, but it highlights that short-term profits aren't overly relevant to the value of a wonderful business that has the opportunity to grow over the long term. Of course this assumes that this wonderful business has the ability to get through an extended tough period.

2. ***We know that in the face of uncertainty, most investors' investment horizons shorten.*** What type of businesses do you think people feel most comfortable owning in the current environment? You're probably guessing grocery stores, pharmacy chains or utility companies. You're right. Let's call these types of companies the obvious survivors. People feel comfortable owning the obvious survivors now because even with all the fog blurring their long-term vision, they know that the local grocery store will still be open for business tomorrow and that their utility company is still going to deliver electricity. It's this high level of confidence for the short-term outlook of these businesses that causes people to want to own them today. When most investors feel this way, that becomes an issue. As everyone else has the same high level of confidence for the near future of these "obvious survivors", their relative long-term attractiveness diminishes, as the pricing inefficiencies are wiped out.

   So, how are we at Cymbria investing right now? Our investment horizon remains long and we're looking to concentrate your Portfolio in non-obvious survivors. What's a non-obvious survivor? We believe it's a business whose short-term outlook isn't as rosy as a grocery store's, but that's just as likely to make it through this crisis and come out the other side even stronger. These non-obvious survivors have seen their share prices temporarily impacted because the short-term visibility around their business is poor, even though they have a very high probability of thriving over the long term. We believe the short-term fog around these businesses is letting us buy their future growth for free. If history is a guide, as things recover (i.e., the fog lifts) the market will pay us for that growth through material price appreciation. Said differently, if history is a guide, today's non-obvious survivors should materially outperform in the future.

3. **We know that we won't try to predict what the stock market is going to do in the short term.** You have likely seen the long-term stock market charts that show how despite many recessions and bear markets, over the long term, stock markets tend to go up and generate pleasing returns. There's no reason to believe that this time will be different. Rather than predicting short-term market movements, we're focusing all our efforts on understanding the long-term value of the businesses you own.

4. **We know that panic is near an all-time high.** Stock market volatility is a good measure of panic. If you were born after the Second World War, only once before have you seen more volatility than in the past couple of weeks. You have probably seen the studies that show that a good time to invest in the stock market is when most market participants are frozen with anxiety. We won't bore you with another study, but we would like

to note that we're not frozen. We endeavour to live in a narrow emotional band during times like this so we can take advantage of the opportunities that present themselves when irrationality permeates the markets. Your Cymbria team is constantly trying to upgrade the quality of the portfolio you own, not for tomorrow, but five years from now.

5. **We know that it's scary, but it's not the first scare that we've witnessed in the markets and it won't be the last.** Betting against human ingenuity to find a solution has usually been a bad bet. Listed below is a list of a few other scary times the world has been through and how the stock markets reacted. The third column shows what happened to the S&P 500 Index during the particular crisis. The subsequent three columns show you the 1-, 5- and 10-year returns, coming out of those periods. Investors who took a long-term view were rewarded for staying the course during the tough times:

Event	**Event dates** Peak-to-trough	**S&P 500 Index performance…**			
		During event	**1 year later**	**5 years later**	**10 years later**
Fall of France	May 9, 1940 to Jun. 22, 1940	-18.2%	5.2%	15.9%	13.2%
Attack on Pearl Harbor	Dec. 6, 1941 to Dec. 10, 1941	-6.9%	16.0%	18.1%	17.1%
Outbreak of Korean War	Jun. 23, 1950 to Jul. 13, 1950	-11.1%	42.0%	27.6%	18.4%
Cuban Missile Crisis	Aug. 23, 1962 to Oct. 23, 1962	-9.9%	41.1%	15.8%	11.0%
Nixon resigns	Aug. 9, 1974 to Aug. 29, 1974	-13.4%	30.6%	14.6%	14.6%
1987 stock market crash	Oct. 2, 1987 to Oct. 19, 1987	-31.5%	27.9%	17.0%	18.9%
Gulf War ultimatum	Dec. 17, 1990 to Jan. 16, 1991	-2.8%	36.6%	17.3%	18.0%
Collapse of Long-Term Capital Management	Aug. 28, 1998 to Sep. 9, 1998	-2.0%	35.8%	1.8%	3.7%
September 11th terrorist attacks	Sep. 10, 2001 to Sep. 21, 2001	-11.6%	-11.1%	8.3%	3.9%
U.S. invades Iraq	Mar.18, 2003 to Mar. 31, 2003	-2.1%	35.1%	11.3%	8.5%
Collapse of Lehman Brothers	Sep. 5, 2008 to Nov. 20, 2008	-39.1%	48.8%	21.5%	15.8%
U.S. debt downgrade by S&P	Aug. 5, 2011 to Oct. 3, 2011	-8.0%	35.0%	17.0%	–

Source: Putnam Investing, "Markets recover from crises", February 2020. https://www.putnam.com/literature/pdf/II511-4665ccf3000b8e3f349cca07453104c7.pdf. Total returns in US$. Returns for periods greater than one year are annualized. The S&P 500 index is a broad-based, market-capitalization-weighted index of 500 of the largest and most widely held U.S. stocks.

6. **We know we're putting our money where our mouth is.** EdgePoint employees are collectively the second-largest investor in our company related products. Specifically, EdgePoint partners collectively had $322 million invested in our portfolios, including Cymbria. This is money we have earmarked to feed, shelter and clothe our families in the future. Over the last few weeks, the company and EdgePoint employees have added in excess of $10 million to company-related products. We strongly believe in the long-term opportunities embedded in our portfolios and are investing behind that conviction.

7. **We know that staying the course isn't easy for many investors.** If it were easy, all investors would be rich, but they're not for a reason. I'm sure you've heard many stories on the power of compounding. For example, if you invest $100,000 and it grows at 8% annually for 30 years (lower than the long-term average return of the stock market) you will have over $1 million 30 years later. Why, then, are most investors not able to achieve this type of a return? We believe the answer is that staying the course during times of uncertainty can be brutally difficult for most. When the "fog of war" takes hold like it has over the last few months, many just find it easier to exit the market until things get better. Their thinking is that when the "fog of war" lifts, they will re-enter. The problem is that by the time the fog lifts, much of the upside has already been recognized and they have missed out on a big part of the recovery. If history is a guide, the stock market bottoms out well in advance of the wider economy. We have no reason to believe that this time will be different.

These are difficult times for the world. There's a lot of uncertainty. During periods like this, it helps to have something to believe in. At Cymbria, we believe in our investment approach. Thinking and acting like a rational business owner has proved to be a successful investment approach in the past, and we believe will prove to be a successful approach in the future. This means taking a long-term view. Great businesses have the ability to compound wealth over the long term. Short-term profit declines can always happen but they represent only a small part of the investment journey. We thank you for your trust during these difficult times and want you to know that we understand the gravity of the responsibility you have entrusted us with. We continue working hard to be worthy of that trust.

[i] 2008 Financial crisis.

[ii] As at December 31, 2019.

Published April 2, 2020.