CYMBRIA®

We understand the gravity of our responsibility to you (part 2)

By Tye Bousada, portfolio manager

Things have improved considerably since we wrote Part 1 three months ago. At this time, the worst-case scenario for the virus and the global economy seems to have been avoided and your Portfolio recovered a significant portion of the losses experienced in the first quarter. However, the investment climate remains highly volatile.

1. From Point A to Point B is never easy
2. The importance of uncertainty in building long-term wealth
3. The willingness to look wrong in the short term so you can be right in the long term
4. Activity in your Portfolios

From Point A to Point B is never easy

You're at Point A today and have a financial goal sometime in the future, which we'll call Point B. Many investors search for the secret path of success to Point B. You know the path we're talking about – the magical low-volatility, high-return investments that can deliver consistently pleasing returns without ever making you feel uncomfortable to be invested in them. The problem with that path is we aren't aware of anyone who's found it – ever. However, even though the path is pure fiction, most investors make investment decisions thinking it exists. Said differently, investors have a tendency to make investment decisions about their long-term goals (Point B) based on how they feel today (Point A). Making long-term investment decisions based on how you feel today has never proven to be a successful long-term strategy. Let's be even more blunt. If history is a guide, making long-term investment decisions based on how you feel in the middle of a crisis usually results in the average investor never attaining their Point B goal. That's code for running out of money before you die.

In the face of today's uncertainty caused by COVID-19, the average investor seeks investments that make them feel comfortable today. Since almost everyone is seeking the same thing today (Point A), there are lots of opportunities to make subpar returns on the path to Point B.

Treasury Bills are a good example of what people want to own today. Since everyone is looking for the safety of T-Bills, the price has been bid up to the point where the yield on the 30-year government of Canada bond is less than 1%.[i] People are fearful today (Point A) and, as such, are willing to accept less than 1% a year for 30 years in return for feeling comfortable. If you believe inflation will continue to average well above 1% annually like it has in the past, then that means anyone owning these bonds today is comfortable owning something that guarantees the erosion of their savings for the next 30 years. What makes them feel comfortable at Point A today is terrible for their Point B.

Many income funds are similar. Although such funds can offer a yield slightly above 2%, after accounting for fees, that yield is eroded to something closer to 1%.[ii] The price of comfort is very high, as is the risk associated with many of these income funds.

If the average investor wades into the stock market, they tend to feel comfortable buying two types of businesses – the obvious growers and the obvious safety names. Let's briefly talk about each one of these.

The obvious growers

When the stock market becomes extremely volatile like it has over the last five months, investors tend to seek out businesses with a high probability of growing in the short term. Let's use Netflix as an example. Everyone knows Netflix is going to grow during the pandemic because people are staying home more often and watching more shows. The problem is everyone knows this and, therefore, the future expectations of growth are likely already more than reflected in the share price.

When you make an investment in the stock market there are only two potential outcomes – you're either making a mistake or capitalizing on someone else's. Your relative gain will be someone else's relative loss, or vice versa. How do you increase the probability of being the one to win in this equation? The answer is you must have a view about the

business' future that's not currently reflected in its share price. Said differently, you should know why the business you're investing in will be bigger in the future than the market currently believes. If you can answer this question, you likely have a proprietary view. If you can't answer it, you're likely making a mistake investing in it.

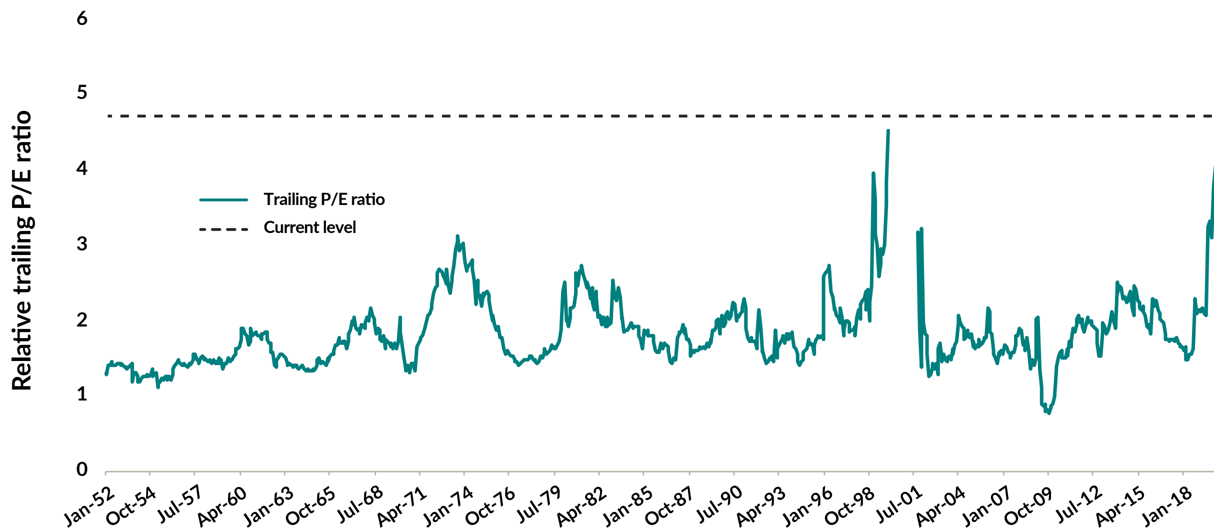
Back to Netflix. Netflix makes the average investor feel comfortable today because it's going to grow in this volatile world. This comfort around Point A causes people to invest in Netflix despite not having a view on how the business might help them achieve their Point B.

Here's the problem with doing what makes you feel comfortable. You aren't unique and, as such, most people are doing the exact same thing you are – in this case, seeking the comfort of the obvious growers in the stock market. This "herd mentality" results in rising valuations. Although owning an obvious growth stock makes you feel comfortable today, overpaying for a business because it makes you feel comfortable in the short term won't help you get to Point B.

The chart below shows how richly valued the obvious growers are today relative to the rest of the market. More specifically, it's a study of the large-cap universe of companies in the U.S. (830 companies). It shows the relative valuation (based on price-to-earnings ratio) of the 75 fastest-growing companies in the U.S. relative to the rest of the universe. The chart shows that since 1952, people have almost never paid more than today, on a relative basis, for the comfort of owning obvious growth businesses. Said another way, at virtually all times over the past seven decades, these obvious growers have been relatively less expensive than they are right now.

Big Growers relative trailing price-to-earnings (P/E) ratio

Jan. 1952 to Jun. 8, 2020



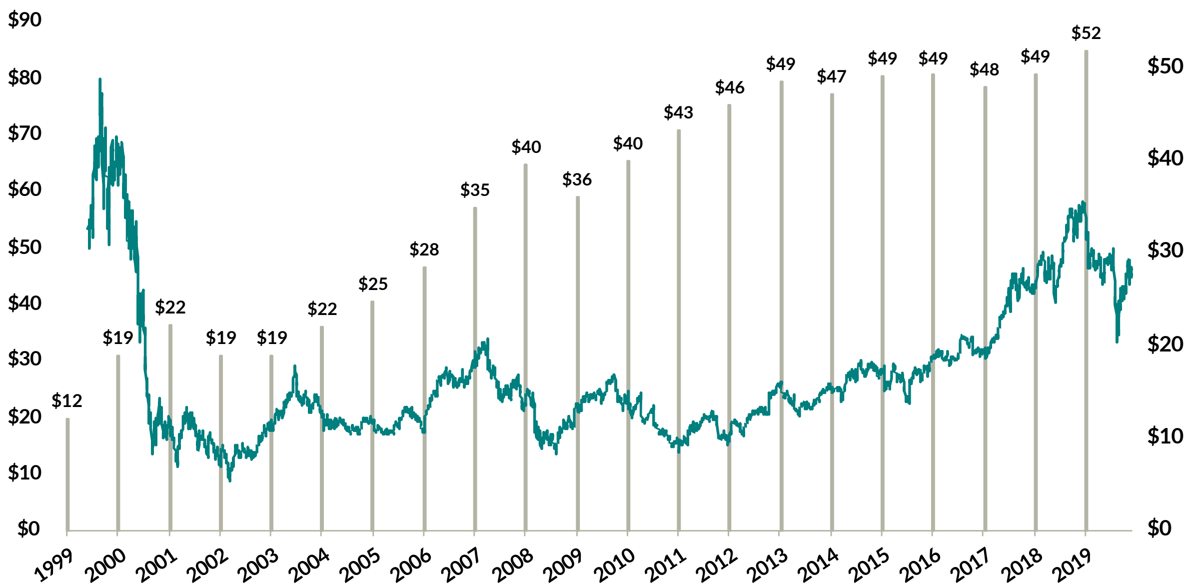
Source: Empirical Research Partners Analysis, National Bureau of Economic Research. Big Growers are a group of approximately 75 large-capitalization stocks classified by Empirical Research Partners, LLC to have faster and stronger growth credentials than the rest of the market. Trailing P/E ratios are equal-weighted and relative to the rest of the U.S. large-capitalization universe. Data between January 2000 and September 2001 was excluded due to extreme valuations.

A full list of the "Big Growers" is included here.

Please note that we aren't saying the big growers are bad businesses. The truth is, there are many great businesses on this list. In the past we have owned several of these businesses, such as Ubiquiti and Lululemon. However, we held them at valuations

that were much lower than today and when our views about the future growth of these businesses weren't widely shared by the market at the time.

Let's use a historical example to further drive home this point. In 1999, everyone knew the internet was about to go through an explosion of growth. Cisco sold the "plumbing" required to make the internet work – specifically routers and switches. As such, everyone knew Cisco was going to deliver a tremendous amount of growth into the distant future. Fast forward 20 years and we can say today that everyone was right. Cisco's revenue over the last 20 years increased by about 330%. However, in spite of this growth, had you made an investment in Cisco back in 1999, you would have LOST money over the last 20 years because you would have paid an extremely high price for it. The average investor felt comfortable owning Cisco in 1999 because it was an obvious grower. That comfort led to permanent loss of capital, as the price of comfort was very high for Cisco investors.



Source: FactSet Research Systems Inc. Annual revenues are shown for the end of the calendar-year, but Cisco's fiscal year ends on July 31, 2020. All annual revenues are as at July 31 for the specified year.

The inescapable reality of investing is that the entry price dictates returns. If you pay too high a price for a great business, you can still lose money. Overpaying for anything doesn't help you get to Point B, no matter how comfortable it makes you feel today.

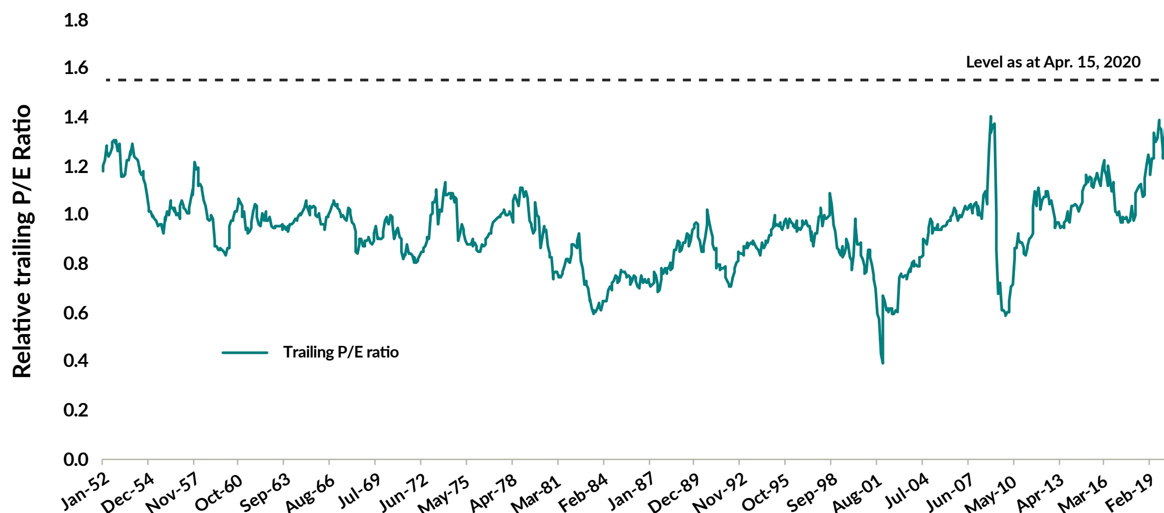
The obvious safety names

Since the start of the pandemic, the average investor has also felt comfortable investing in businesses with below-average volatility in their business models and, by default, their share prices. Businesses that fall into this camp would include telecommunication, pharmaceutical and packaged goods companies. Colgate is an example of a packaged goods company. Today's comfort stems from the thought that no matter how challenging next year turns out to be, the same number of people will still brush their teeth using Colgate as last year.

Again, the problem with this simple narrative is that everyone is thinking the same thing and, just like the obvious growers, the relative valuation of the obvious safety names reflects this common view.

The chart below shows the relative valuation of these low-volatility obvious safety names relative to the rest of the large-cap universe, dating back to 1952. It shows the relative valuation of 166 companies with the lowest share price volatility compared to the rest of the universe. Like the previously mentioned obvious growers, the obvious safety names have never been more expensive relative to the rest of the market than they are today. In our opinion, that's not a good starting point if you hope to successfully reach your Point B.

U.S. large-capitalization stocks in the lowest beta quintile
Relative trailing P/E ratios vs. the rest of the largest-cap universe
Jan. 1952 to Apr. 15, 2020



Source: Empirical Research Partners Analysis, National Bureau of Economic Research. The group of companies are large-capitalization U.S. stocks in the lowest quintile of beta. There are total of 166 companies in the lowest quintile group. Beta is a measure of an individual stock's volatility relative to the market. Stocks with a beta of 1 move in line with the market. The lower the number, the less volatile a stock is relative to the market, while a higher number indicates that the price is more volatile compared to the market.

A full list of the obvious safety names is included here.

The importance of uncertainty in building long-term wealth

If everyone agrees on what the future will look like, then the possibility for outsized future returns is materially diminished. In fact, if everyone was certain about the future, the most that someone could earn from an investment would be the risk-free rate of return (a return not too dissimilar to the 30-year Government bond yield of 1% that we mentioned earlier).

Historically, Cymbria thrived during uncertain times. We used past periods of volatility like the global Financial Crisis, the European sovereign debt crisis, the U.S. debt downgrade and the emerging market slowdown of 2015 to buy great businesses that were going to grow – without having to pay for that growth. Capitalizing on uncertainty is what has allowed us to turn $1 invested Cymbria in November 2008 into more than $4 by the end of 2019.[iii]

The conclusion to be drawn is that uncertainty is a necessary ingredient for achieving pleasing long-term returns and the only way to get to your Point B is by weathering the uncertainty that the stock market inevitably brings.

The willingness to look wrong in the short term so you can be right in the long term

We understand that we likely don't appear intelligent right now. We also looked wrong many times before and each and every time it felt uncomfortable. We really wish we could always look right, but no one has ever managed to always look right in the short term. We realize it isn't a realistic aspiration. What we believe matters the most is long-term outperformance. We realize that in order to deliver long-term value, sometimes we must be willing to look different in the short term – even if it means looking wrong. We believe this time is no different than previous periods of uncertainty. We understand it isn't comfortable to own an investment that looks different in the short term, but believe it's necessary to achieve long-term outperformance. To support this statement, let's look at an example.

Joel Greenblatt is a famous investor and author of *The Big Secret for The Small Investor*.[iv] In this book he recounts how overall stock market performance was essentially flat during the decade from 2000 to 2010, yet the best-performing mutual fund returned 18% per year. Pretty good! How did the funds' investors do? On average they lost 11% a year on a money-weighted basis. How do you lose 11% per year in an investment that compounds at 18% annually for 10 years? It's easy – buy it when it's doing well and sell it when it's doing poorly. This is what investors do when they're not willing to look wrong in the short term.

Greenblatt also analyzed the top quartile of managers over the 2000 to 2010 period (i.e., those who outperformed 75% of their peers), and showed that:

- 97% of managers with the best 10-year record spent at least three years in the bottom half of the group
- 79% of managers with the best 10-year record spent at least three years in the bottom quartile (bottom 25%) of the group
- 47% of managers with the best 10-year record spent at least three years in the bottom decile (the bottom 10%) of the group

Activity in your Portfolios

We've been quite active in the Portfolios since the beginning of the COVID-19 crisis. Since January we added 12 new ideas to Cymbria alone.[v] As many of you know, we typically only add about six new ideas in a year.

We've followed many of these new ideas for well over a decade. We waited patiently for a short-term catalyst that would allow us to buy their future growth for free. It turns out the pandemic was that catalyst.

Examples of businesses we purchased:

- We purchased a business that will benefit from fewer people taking public transit and more people using private vehicles going forward. This same business will benefit from the average age of the cars on the road increasing, which usually happens during a recession. The business has more than doubled its earnings per share in the last five years and we think it can do the same over the next five years. When we started buying it, we were being asked to pay approximately 14 times earnings for it. In other words, we weren't being asked to pay for future growth.
- We purchased a technology services company in Japan that should be able to double its profit margins in the next three years while also growing its revenue. Japanese companies have underinvested in IT infrastructure for decades and it's finally caught up with them. Their spending in this space will increase and this company has one of the best solutions to help. When we bought it, it was trading for around 10 times earnings. Again, we weren't being asked to pay for growth.
- We purchased a global quick-serve restaurant business that saw the majority of its businesses stay open during the crisis. This company owns three brands and today two of them are experiencing flat-to-moderate growth on a year-over-year basis. Looking forward, we believe all three brands have

room to increase their profitability, but one brand in particular has the potential to more than quadruple in size. This business has more than doubled its earnings in the last five years. When we bought it, it was trading for around 10 times earnings. And, you guessed it, we weren't being asked to pay for growth.

- We purchased a global propane distributor. Homes still need to be heated and cooled, pandemic or not. This business came into the crisis with absolutely no debt, which puts it in a good position to acquire market share going forward. The management team has a long history of completing acquisitions that have benefited shareholders, and now the company has the perfect environment and balance sheet to complete even more acquisitions. They are a great operator, as evidenced by their ability to increase profits for the last eight consecutive years. We think they have a chance of increasing their earnings by almost 70% in the next five years. When we bought it, it was trading for around 14 times earnings. It should come as no surprise that we weren't being asked to pay for growth.

Conclusion

These are challenging times for the world and there remains considerable uncertainty. During difficult periods like this, it helps to have something to believe in. At EdgePoint, we firmly 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 it will prove to be a successful approach in the future. These aren't just empty words – we back these beliefs up with action. At the beginning of this year, as a group internal EdgePoint partners were the second-largest owner of the same Portfolios you own. Since the COVID-19 crisis hit, the internal partners have increased their positions in these same Portfolios by more than 10%.

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] Bloomberg LP. As at June 30, 2020.

[ii] Morningstar Direct. The universe of funds analyzed only includes funds with available duration and yield-to-maturity values, as well as a minimum AUM of $2 billion in the Canadian Fixed Income category. Series A MER was used to determine an after-fee estimation of the yield on the fixed income category. MER and yield-to-maturity was taken directly from fund websites. If not disclosed, Morningstar was used.

[iii] Based on Cymbia aNAV. Period measured from November 4, 2008 to December 31, 2019.

[iv] Greenblatt, Joel, The Big Secret for the Small Investor: A New Route to Long-Term Investment Success (New York: Crown Publishing Group, 2011)

[v] Number of new businesses added to the Cymbria Portfolio from December 31, 2019 to June 30, 2020.

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