Written by Geoff MacDonald

One of our commitments at EdgePoint Investment Group is that we will communicate regularly and honestly with our shareholders because informed investors make better decisions.

While we aim to exceed the performance of the major stock market indices over the long term, we do not pay much attention to relative results in any given quarter or year. Although our comments may address the most recent quarter, we do this only because it reflects industry convention. Typically quarterly commentaries focus on “what went up” and “what went down” during the preceding quarter. Focusing one’s readers on such short-term increments causes the readers to simply observe the variability in their portfolio of companies and nothing else. We don’t see the purpose in trying to fool our readers with such randomness.

As I’ve commented on in the past, business values and market values tend to be more closely aligned over the long term. Thus, we will try to focus the majority of our commentaries on the operating results of the businesses we own and/or the factors that impact their long-term values. We may also add other insights over time that may help you become more informed about our investment approach.

Focusing on Strong Companies

We’ve certainly witnessed an overdose of emotion in the past few months. That’s not a bad thing, unless of course, it was us who were getting overly emotional. Unfortunately, highly emotional investors tend not to make good decisions when faced with large market fluctuations. They typically buy more equities when the outlook is superb and prices are high. However, the rosy outlook tends to already be reflected in the high price, thus limiting the chances of outsized returns. Not to mention the fact that with higher prices comes higher risks. Investors like clarity. As a result, they will pay more for businesses that have a clearer outlook, without necessarily asking about the consequences should fog appear on the horizon.

The opposite, of course, is happening today. Prices have dropped substantially yet investors are fearful. The fear and uncertainty is understandable. Global economies are slowing down or shrinking, banks are being bailed out, corporate profits are declining, and formerly sensible people are predicting the end of the world. However, these much lower prices mean there is less risk investing in companies today than there was one or two years ago (for the surviving companies that is). We have a simple view of risk. A low price for a high-quality company is less risky than a higher price for that same high-quality company. Conveniently, a low price for a high-quality company also offers more upside. It’s the simplest of all concepts to understand, yet the most ignored concept in the market by the masses.

We certainly have no intention of downplaying the global economic situation we are facing. Though credit markets are improving and much of the de-leveraging has been completed, global economies could easily stay in the current depressed state for many months to come, perhaps another year. In such an environment, many companies will head towards zero. While it sounds severe, it is not unreasonable. Just as 50% of all doctors finish in the bottom half of their class, 50% of all businesses rank in the bottom half of their respective industries. In a growing economy, it may not be obvious to the average investor who the weaker companies are, as a rising tide lifts all boats; however, it becomes quickly evident in a shrinking economy. Weak companies become weaker much faster in a recession while the opposite is true of strong companies.

Companies with a strong competitive advantage (i.e. cost and scale advantage, superior brand, stronger patent portfolio, stronger balance sheet or simply a stronger culture) will continue to look for ways to grow their business. In a slowing or shrinking economy, this growth often comes from stealing business from competitors who lack these same strengths.

There will be, and already have been, big losers coming out of this period. Rarely has there been a more important time to focus on the quality of the businesses you own.

We would never, therefore, contend that this declining market is completely irrational. Without a crystal ball predicting the timing of an upturn in the economy, permanent loss of capital (or major dilution) awaits those weaker companies who can't quite make it to the turn. The consequences of holding such companies have increasingly become evident to most market participants, and these stocks have gone down materially in price.

But it's not just the weak companies who have seen dramatic drops in their values. The lack of visibility in the economy has resulted in lower prices more broadly. These price declines have brought fear back to the forefront. We've experienced a broad and indiscriminate sell-off of most companies, both the weak and the strong.

What should one do with an obvious survivor who is taking share from its competitors and can be bought or sold today at a fraction of what it will be worth three to five years from now?

To help with that question, we thought you should read Ben Graham's "Mr. Market" story. The following excerpt comes from Warren Buffet's re-telling of the story in his 1987 Berkshire Hathaway Annual Report.

Mr. Market

....you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his.

Even though the business that the two of you own may have economic characteristics that are stable, Mr. Market's quotations will be anything but. For, sad to say, the poor fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains. At other times, he is depressed and can see nothing but trouble ahead for both the business and the *world. On these occasions, he will name a very low price, since he is terrified that you will unload your interest on him.*

Mr. Market has another endearing characteristic: He doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behavior, the better for you.

But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence. Indeed, if you aren't certain that you understand and can value your business far better than Mr. Market, you don't belong in the game. As they say in poker, "If you've been in the game 30 minutes and you don't know who the patsy is, you're the patsy."

It is hard for Mr. Market to overcome and act in opposition to his emotions. Mr. Market also tends to assume near-term trends will continue indefinitely. As you'd expect, we're picking our spots and are taking advantage of his fear and current manic depressive state.

Our founding partners have demonstrated an ability to keep our emotions in our back pocket when investing in the market. Tye Bousada and I treat the daily blips of the market as noise, noise that most investors have difficulty tuning out. Our investment approach and its resulting long-term focus provide a road map to successfully navigate through market turmoil. In other words, our approach equips us to deal with a rise in volatility and/or declining markets. All that we see from recent market turmoil is opportunity.

We wonder what momentum investors do when stocks and earnings go down. What do growth investors do when little is growing? Do their clients patiently wait for these managers to experiment with new modifications to their investment discipline? For us, nothing about this market changes our approach.

Deleveraging, Inflation, and Deflation?

For bottom-up investors in businesses, we've been receiving more than our fair share of questions on the deleveraging process and whether or not investors should focus on investing with the expectation of inflation or deflation for the next several years.

The quantitative easing and capital injections into the U.S. banking system has certainly improved the credit markets in the last few months. Banks have been rebuilding their capital positions and have slowed down the write-downs of their assets. Furthermore, remaining “toxic assets” are starting to be unloaded with the help of the Term Asset-Backed Securities Loan Facility (TALF) - a facility launched by the U.S. Treasury and the Federal Reserve intended to spark the asset-backed security (ABS) market, which includes auto loans, student loans, and credit card loans. In addition, we've also had a record issuance of credit in the last few months.

We certainly feel the worst is behind us with regards to this credit crisis. As every action has a reaction, we've spent more time recently wondering about the consequences of recent moves to fast forward and "fix" this credit crisis.

Do policymakers secretly prefer to help the deleveraging process through inflation? To de-lever, one could cut spending and retire debt. Or one could manufacture inflation where higher prices lift nominal incomes and asset values. It seems obvious where current administrations around the world fall out here. Secondly, many governments appear ready to turn on their printing presses. The U.S. Federal Reserve recently announced it will purchase $300 billion in Treasury bonds and an additional $850 million of mortgage-backed debt, all paid for by printing money. Other central banks have and will follow.

It seems only reasonable these actions of the central bank (i.e. printing money) could devalue idle cash sitting on the sidelines. When the owners of the idle cash recognize such devaluation, they'll likely rush to deploy it. Interestingly, the deployment of this idle cash could be a more important factor in asset price stabilization than any government initiative.

We don't hold a crystal ball when it comes to forecasting the ups and downs of currencies, interest rates, inflation rates, and economies. That said, a fundamental principle of risk management is defining a problem and then asking the right question. In this case, the problem is an increased probability of inflation. The question to ask is, "How would this affect the businesses we own?" Owning high-quality companies at the current attractive prices is the best protection possible to an increasing probability of inflation.

Company Update – Moody's Corp.

Moody's Corporation is a large holding in Cymbria's portfolio. Moody's provides credit ratings and credit-related services globally. The stock, which was once loved by Mr. Market at $70 per share, was purchased below $20 per share. Our investment thesis when we bought it can be summed as follows:

1) The credit crisis will eventually subside
2) Moody's dominant role and business model will emerge predominately intact
3) Corporations will increasingly turn to the public markets for debt financing as banks will be regulated to hold more capital
4) European and Asian markets will grow substantially because their public debt markets are much less penetrated than the U.S. market
5) The above four points were not reflected into the stock price at the time of purchase as it was trading at approximately 10x earnings

The thesis continues to look intact. In the first quarter of 2009, U.S. Corporate Bond issuances were significant and we're not aware of any debt issuances that weren't rated by Moody's. That's a pretty dominant market share in our books.

The strength of Moody's and the importance of the role of the large rating agencies is being proven daily in these credit markets. In the fourth quarter of 2008 and the first quarter of this year, the Bank of England and the European Central Bank have been purchasing structured investments from banks with the criteria that the instruments have a double-A rating or higher by Moody's, S&P, and Fitch. In addition, ABS issuances eligible for TALF require the highest bond rating from a minimum of two agencies which include Moody's, S&P, & Fitch. With the governments (the regulator to these rating agencies!) heavily reliant on the ratings from the "Big 3", it's hard to believe the role of the rating agency will change materially in the future versus what it was in the past.

Moody's plays a significant role in part of the solution to the current credit crisis, which is bolstering their business. We believe the market misunderstands their role and is making an assumption that the credit crisis will continue indefinitely. Moody's business will continue to improve once the credit crisis subsides. Charlie Munger was once quoted as saying "the investment game always involves considering both quality and price, and the trick is to get more quality than you pay for in price. It's just that simple". Moody's is a dominant company with great growth prospects that fits that bill.

While this commentary happens to be particularly long this quarter, you can expect my comments to vary in length depending on what information I have to share at the time (i.e. they won't be long just for the sake of it). I'll do my best to share information that I feel is meaningful to you.

Sincerely,

Geoff MacDonald

Commentary as at March 31, 2009. The above companies are selected for illustrative purposes and are not intended to provide investment advice. EdgePoint Investment Management Inc. may be buying or selling positions in the above securities.