Written by Tye Bousada

The Spotted Zebra versus Fortune Tellers and Noise Makers

There is a small shop beside our office on Yonge Street called the Spotted Zebra. Recently a sign appeared in their window that read “Keep Calm and Carry On”. Intrigued, I walked in and talked to the shopkeeper about the sign. I learned that it was originally designed in the United Kingdom during World War II and would be used in the event that Britain was invaded by Germany. The shopkeeper thought this was good advice for investors given the volatility in the stock market, and decided to display it in the window. I bought a copy and hung it in our office to serve as a constant reminder of the importance of maintaining focus when investing.

History has shown that it is not the economy that tends to hurt investors. Over the medium-to-long term, the economy has grown, and will continue to do so. If history is a good guide, five years from now, the economy will be bigger than it is today or than it was two years ago before the recession started. So if not the economy, what is it that hurts investors’ chances of building long-term wealth? The answer lies partly at the feet of fortune tellers and noise makers.

The stock market is overcrowded with such individuals. They may take the form of analysts at big brokerage firms who are trying to guess whether a company will exceed or miss next quarter’s earnings targets by a penny. Or, they may be the talking heads on TV or the Internet who pontificate about potential fortunes or disasters awaiting the economy the following month. They may also show up as commentators who rush to dissect the meaning of the smallest piece of information delivered by the government about the state of the economy. The fortune tellers and noise makers are very good at getting people to listen. Unfortunately, they are also good at amplifying emotions, such as fear and greed, in investors (both novice and professional), which can cause them to make poor financial judgements.

These poor judgements generally result in investing in line with consensus. For example, buying something not based on fundamentals but because fortune tellers and noise makers universally agree that the price will continue to go higher (think of oil at over $140 a barrel in the spring of 2008 or technology stocks in 1999), or selling something not based on fundamentals but because fortune tellers and noise makers tell everyone they must sell or risk being the last person to leave the party. In most cases, they are in search of a “quick buck” which prohibits them and their followers from focusing on the true value of a business.

At EdgePoint, it is our job to capitalize on these opportunities. We endeavour to acquire ownership stakes in quality businesses 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 it that is not widely shared by others. We must not allow ourselves to fall prey to the fortune tellers and noise makers of the market and invest with consensus.

An example of how our investment approach has added value to Cymbria’s portfolio is BorgWarner Inc. BorgWarner is an auto parts manufacturer. In November of last year, magazines, newspapers, television, and the Internet were full of stories about how the car industry was going to die. Not surprisingly, these headlines scared most investors away from any businesses related to the automotive industry. In reaction to this short-term focus, BorgWarner's shares plummeted. Specifically, they fell from a high of $55 per share in May 2008 to approximately $17 per share in November 2008.

We have followed BorgWarner for years. We've met with its management team a number of times, read their annual reports, visited their competition, talked to industry experts, interviewed their customers, used their products, and built financial models on the company. In November, following the large decline in their share price, we decided to revisit the investment idea. We flew to Chicago where they were presenting at a conference. We wanted to get a better sense of whether the long-term opportunities we had identified still existed given the short-term state of the economy. During the presentation, they confirmed our assessment of the company's risks and outlined their view of the potential growth over the medium term.

On the risk side, they reinforced our belief that Borg Warner was going to be a survivor. They had not overextended themselves with debt during the good times, so we felt confident they could survive during the lean times. Secondly, they emphasized their customer and geographic diversity with only 12% of their products sold to General Motors, Chrysler, and Ford. They did not, therefore, have a material exposure to the North American "Big Three".

As for long-term growth, Borg was well positioned. Their product components increase the fuel efficiency of cars and reduce auto emissions - two areas of huge focus for auto manufacturers given the energy and environmental issues that the world faces. During the conference, they focused on their leading positions in gas and diesel turbochargers which increase fuel efficiency by 15% to 30%. They also discussed their joint ventures in China for dual clutch transmissions (products that allow for 5% to 15% more fuel economy), and highlighted their leading positions in powertrain components for hybrid and electric vehicles.

Borg's consistent focus on research and development throughout the years had paid off. During the last 15 years, Borg grew its revenue at an annual rate of 11.8% per year compared to global auto production, which grew at an annual rate of only 3.0% per year. Borg seemed ready to build on that strong track record. Their share price, however, continued to fall.

As a result of our meeting, our conviction grew stronger about the company's longer-term opportunities. While we did not have any idea when people will start to buy cars again, we knew it would eventually happen. Cars will need to be replaced, and when people finally do replace them, Borg will be a big beneficiary. More specifically, according to our calculations, we were able to buy Borg for approximately six times normalized earnings or the equivalent of a 16% return on our investment.

While the fortune tellers and noise makers prophesized about the end of the global auto industry, we started buying BorgWarner for your account. We tried to "keep calm and carry on" with our investment approach. Since establishing the original position in Borg Warner, your ownership stake in the company has appreciated from $17 per share to over $34, a return of approximately 100%. A material amount of the return that we expected to achieve over a five-year period was delivered to us in just over six months. As such, you should not be surprised to learn that we have materially sold down your interest in Borg and redeployed the proceeds into what we believe to be better long-term opportunities.

In summary, we do our best to approach investing in these turbulent markets with a sense of measured confidence. We will continue to invest behind our convictions irrespective of what the noise makers and fortune tellers have to say. We will always endeavour to "keep calm and carry on".

We thank you for your confidence in us, and look forward to having the opportunity to build wealth for you over the long term. We will endeavour to share with you what we would want to hear if our positions were reversed. Our hope is that you gain a solid understanding of how your money is being invested.

Sincerely,

Tye Bousada

Investment Results: In accordance with the Canadian Securities Administrators' National Instrument 81-102 under which Cymbria is governed, we are not permitted to discuss investment results until Cymbria is one-year old. This information, however, is readily available from publically-accessible websites and newspapers.

Commentary as at June 30, 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.