

Written by Tye Bousada

A Wall of Fear

There is a large wall of fear in the market today, which has been built up by a number of global economic concerns. You are likely well aware of the concerns we are referring to, but for the record, let's list a few of the bigger ones: sovereign debt risks, high global unemployment levels, household deleveraging in developed markets, a potential slowdown in China, a double-dip global recession, and the battle between the dual evils of deflation and inflation. This, of course, is not an exhaustive list of worries, but represents the solid foundation of the wall of fear in investors' minds today. In our judgment, these are all very real concerns. We have been, and continue to be, of the opinion that the global economy could be slower for longer than people expect. Given that the majority of publicly-listed companies around the world depend largely on economic growth to drive growth in their own businesses, the broad stock market could conceivably stagnate for a period of time well into the future.

Fortunately, we are not in the business of buying the stock market. Instead, we are focused on buying individual stakes in businesses that can grow irrespective of what happens in the economy (within a band of reason). At the same time, we look for businesses where we are not paying for that growth today. The large wall of fear that exists today has created an opportunity to purchase many of these types of businesses.

Since the financial shock of late 2008 and early 2009, investors have disproportionately focused on risk at the expense of returns. As a result, investors tend to sell anything they perceive as risky. It is this arbitrary selling that creates opportunity. Please do not interpret these comments as us "cheerleading for the stock market". As we said earlier, we believe things can be slower for longer which means limited upside for the stock market. However, during periods of indiscriminate selling, businesses that are able to grow through economic malaise are thrown out with the vast majority of businesses that can't. It's our job to find these mispriced opportunities.

When the wall of fear is as massive as it is today, this task becomes much easier to accomplish. The reason for this has to do with human misjudgment. History has shown that most investors tend to be most pessimistic at points of opportunity and the most optimistic at points of extreme risk. Looking back at the last 30 years of stock market history has shown that some of the riskiest periods existed when there was no wall of worry in investors' minds. Specific examples include:

1. **The early 1980's** when it was the common belief that oil prices could only continue to increase. The price of oil subsequently declined over the next two decades.
2. **The late 1980's** when investors only thought the Japanese stock market would continue to rise. The Japanese market remains approximately 75% below those peak levels to this day.
3. **The 1990's** when there was no question that the new economy was the place to be. Nortel is the poster child for this era.
4. **The mid-2000's** when investors believed the U.S. real estate market could only go up and would NEVER fall in value.

During these periods of time, investors were not climbing walls of worry. Instead the vast majority was focused on returns at the expense of risk – the inverse of what we are seeing today.

Investment Options

Investors generally have four investment “buckets” to choose between: cash, fixed income, real estate, and equities. Let’s consider the attractiveness of each.

Cash

Cash has historically proven to be the absolute worst investment to own over any meaningful time period. The value of cash declines by the rate of inflation each year less the nominal amount earned on it. Let’s suppose inflation is 3% per year for the next decade and you earn a 1% return on cash. By simply owning cash, you will be 22% poorer 10 years from now.

Fixed Income

This is the hot “bucket” right now, or said another way, the investment alternative where the wall of worry is very small or non-existent. There is so much money chasing fixed income today that yields have been driven down to very low levels. We believe this reflects a greater focus on returns that has come at the expense of risk. Let’s consider a few examples to substantiate this point.

1. JAPAN

The government of Japan has a debt to GDP ratio that is twice as high as Greece’s. They source more revenue from debt issuance each year than they do from tax collection (this is not a typo). Approximately 26% of their tax revenue goes towards paying interest on their debt and this ratio is increasing by the day. They are facing a dire demographic situation where the workforce is retiring and is not being replenished by the next generation of workers. Yet even in the face of these problems, investors continue to lend the government money at very low rates. Let’s be more specific. For the privilege of borrowing money for a 10-year period, the Japanese government will pay investors 1.1% per year. Is this an attractive rate for the risks involved? We believe it reflects the lack of any kind of worry in the fixed-income market today.

2. SPAIN

You are likely familiar with the large number of issues facing Spain today so we will not rehash them here. Imagine that the government of Spain came to see you and asked to borrow some money for the next 10 years. What interest rate would you demand in exchange for taking on the mountain of risks that you might not get paid back? If it is higher than 4.6% a year, then you are out of luck because that is the going rate for 10-year Spanish government debt. This, in our judgment, is another example of too much emphasis on returns and not enough emphasis on the potential for permanent loss of capital in the fixed-income market.

Real Estate

To understand the income potential from an investment in the real estate market, let's do some simple math.

1. Take the sale price of home that has recently sold.
2. Estimate the amount of annual rent that could be collected from that property.
3. Subtract the general maintenance costs (i.e. property taxes etc.) from the total annual rent
4. Divide this amount by the sale price of the home.

Our guess is that you wind up with a number somewhere between 4% and 5%. This figure represents the income return from that investment.

Now let's assume that the landlord wanted to use a mortgage to buy the home. Today, the 10-year fixed rate mortgage at most Canadian banks is approximately 5.6%. How can a landlord earn between 4% and 5% on an investment and pay out 5.6% in interest on the mortgage? The answer is they can't or they would go bankrupt.

Most houses today trade below 5% returns because they are purchased for personal reasons rather than for investment purposes. Homeowners generally receive a non-financial benefit from their homes and are therefore willing to pay a higher price. However, when housing prices fall, which happens in every cycle, the buyer of last resort is usually the financial buyer looking for an adequate return. Look at the recent experience in the United States as an example of this. Today, there is no wall of fear in most Canadian real estate markets, and this is reflected in today's house prices.

Please note – we are NOT calling for a correction in Canadian real estate prices. We're solely pointing out that due to a lack of fear, higher current prices mean lower future potential returns.

Equities

Equities seem to be the only bucket where investors appear to be climbing a meaningful wall of worry. As we remarked above, while we believe there are reasons for concern, investors tend to be indiscriminate in their zest to sell equity holdings, resulting in buying opportunities.

Let's look at an example of a company in the portfolio.

WellPoint Inc. is the leading health benefits company in the United States serving the needs of approximately 35 million medical members. One in nine Americans receives coverage for their medical care through WellPoint's affiliated health plans. At EdgePoint, we view WellPoint as a toll bridge over which Americans need to travel before receiving healthcare. As the owner of the toll bridge, WellPoint is able to charge a small fee for its services, providing WellPoint with very attractive return characteristics. If a new drug is invented, a WellPoint medical member would acquire it through WellPoint's network at a price that is marked up by a small percentage. WellPoint doesn't incur any research and development risk to create the drug as it only resells approved products and services through its healthcare system. Members are willing to

pay WellPoint a small fee on top of the regular healthcare costs because WellPoint is more efficient at delivering these services in the marketplace. These cost efficiencies more than offset the incremental cost a member has to pay to access WellPoint's network.

One of WellPoint's largest growth drivers is the anticipated increase of healthcare usage due to an aging demographic. An unfortunate reality is that as people age, they use exponentially more healthcare. According to a 2008 Blue Cross Blue Shield study, per capita life expenditure on healthcare in the U.S. is \$316,000. Nearly one third of this is incurred during middle age and nearly half during senior years. For survivors to age 85, more than one-third of their lifetime expenditures will accrue in their remaining years. With these trends as a backdrop, it's easy to see how the rapid aging of the U.S. population will only cause the rate of growth in healthcare expenditures to accelerate in the future.

Pricing is another important driver of growth for WellPoint. Historically, the annual cost of products and services has risen at a faster rate than the broader market rate of inflation.

If you were to combine the rate of growth of healthcare usage with the growth rate of inflation of healthcare products and services, one can easily arrive at a total rate of growth for WellPoint in excess of 10% per year. For the purposes of our example, however, let's be overly conservative and assume that the future growth rate is only 5% per year. With a 5% growth rate per year, what is the outlook for an investment in WellPoint?

WellPoint currently trades at less than 8 times earnings. Stated another way, if you were to buy 100% of WellPoint, you would receive an annual return on your investment of 12.5% before any assumption for growth. Adding in the 5% growth outlined above results in a 17.5% annual return potential.

Why is WellPoint's growth not priced into its current stock price? The answer, in our opinion, is the wall of fear. Investors are worried about the litany of issues outlined earlier, most of which won't impact WellPoint. A slowdown in China or European sovereign debt defaults won't reduce the aging of the U.S. population and the resulting increased demand for healthcare. Nonetheless, investors are fearful of equities, and are selling shares of WellPoint along with their other equity holdings.

As a final point, we believe WellPoint looks even more attractive when compared to investment alternatives. Specifically, WellPoint stacks up nicely vs. cash at 1%, Spanish debt at 4.6%, or real estate at 4% to 5%. There is a wall of fear facing equities as a whole and WellPoint specifically, whereas there does not appear to be any worry when it comes to investments in cash, fixed income, or real-estate.

In summary, we are attempting to approach investing in these turbulent markets with a sense of measured confidence. The cloud of fear that is hanging over the global capital markets is large, creating what we believe to be select opportunities to build material wealth in the future.

We thank you for your confidence in us, and look forward to having the opportunity to build wealth for you over the long term.

Sincerely,

A handwritten signature in blue ink, appearing to read "Tye Bousada". The signature is stylized with a long horizontal line above the first name and a similar line below the last name.

Tye Bousada

Commentary as at June 30, 2010. 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.

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