Written by Geoff MacDonald

In the previous EdgePoint Canadian Portfolio commentary, I wrote about the opportunities we were finding in the marketplace. Specifically, we were able to find high-quality companies whose future growth potential wasn't reflected in their share prices because of the pessimism and worry of so many investors. These worries included: inflation, deflation, high government debt levels, the strength of consumer spending, the potential for stocks to revert back to their March 2009 lows, high unemployment rates, and rising interest rates.

This list of worries has continued to grow. Added to these fears include the risk a global slowdown as a result of recent austerity measures, as well as an increased probability of a double-dip recession. All of this has increased the bearish outlook of the average investor.

Though this sounds like bad news, it is actually very good news for a purchaser of businesses. The return on an investment is the function of many things, however none more important than the original entry price. Getting the entry price right is very difficult when the seller of a business is incredibly excited about the future. The seller will demand a higher price when the prospects appear positive.

Getting the entry price right is much easier when the seller of a business is manically depressed about the future prospects. Today, manically-depressed sellers of businesses are lining up to sell companies to those who have the capital and desire to invest in the future. The heightened level of anxiety and fear amongst sellers is tilting prospective returns towards the buyers of many of these businesses.

As a result, these worries about the future are providing some wonderful investment opportunities. This does not mean, however, that we are not worried about the future. From the launch of our portfolios in November 2008, we've suggested that the global economy could be "slower for longer" and have stressed the importance of investing in businesses that have the potential to thrive in this type of environment.

Two Types of Investors

There are two types of investors in the marketplace: those who mistakenly believe they have a crystal ball (those who think they know) and those who realize there is no crystal ball (those who know they don't know). Those who mistakenly believe they possess that magical crystal ball always find their own fate. But the others who recognize that the future is always uncertain should be constantly looking for risks and asking about consequences.

Here's an example of what we mean. For some time, we've been concerned about long-term inflation and the dramatic consequences it can have on long-dated bonds and the average company. Note – we only own low-duration bonds in our balanced portfolios and own, few, if any, average companies. We recognize that interest rates are very low relative to where you'd expect them to be over the long term. What if interest rates were to climb by a few percentage points? Would this have a dramatic impact on the companies you own? Can we expect multiples to expand with rising interest rates? This is an example of a type of risk and the potential consequences that we spend time thinking about. The more important question however, is "what other risks exist that have not yet been recognized?" It is these types of worries that will have a significant impact on prices if and when they materialize.

China

Here's an example of this. While most people are aware that there has been an investment bubble in China in the past number of years, investors have only recently started to worry about a potential slowdown in China. We wonder whether these worries are fully reflected in the stock prices of resource companies. We have spent a lot of time thinking about the potential consequences to the companies we own should the bubble deflate quickly versus gradually. These are the types of questions one should be asking now, and not upon further evidence of a potential slowdown. You don't need a crystal ball to see the outcome. You only need to understand the potential impact in order to assess the risk.

When looking for evidence that the Chinese authorities have extended too much credit in this recent financial crisis, one doesn't have to look much further than residential real estate. Approximately one third of China's capital spending is on real estate. The value of residential real estate in Beijing and Shanghai now equates to approximately four times local gross domestic product (GDP), a ratio similar to that of Japan's at the peak of its 1990 bubble. This value also equates to approximately one third of all Chinese GDP. To put this figure in perspective, in 2006, prior to the collapse of the U.S. housing market, homes in California and Florida were valued at approximately half of U.S. GDP.

With almost half of Canada's benchmark index, the S&P/TSX Composite, comprised of resource companies who brag about their dependence on Chinese growth, we wonder if this worry and the potential consequences receive enough attention.

The Portfolio is certainly not immune should China slowdown. We do feel, however, that we are better positioned than the typical Canadian equity fund for a few reasons.

> (1) With only a 19% exposure to resource-related companies, we have significantly less exposure than many Canadian equity funds.
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> (2) There is a dearth of base metal and material-related companies in the Portfolio – the types of companies that would be most exposed to a slowdown.
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> (3) Many of the portfolio's resource-related companies are small energy-related businesses that have meaningful ways of growing their business, even in the face of slow economic growth. Calfrac Well Services Ltd. and Total Energy Services Inc. are examples of this. Calfrac is benefitting from the secular growth towards horizontal multi-frac drilling while Total Energy has a unique opportunity to increase its market share in the natural gas compression business.

Time will only tell if our concerns about a potential slowdown in China are founded. Our belief, however, is that this type of thinking can lead to a portfolio of companies that looks and performs differently from the crowd.

Worries are a worrying thing if you are unaware of how your investment will perform should the worry come true. Not worrying about what others have yet to worry about will have you always reacting to price moves after they've already happened. On the flip side, taking advantage of other people's worries, where the worries are overly discounted in the purchase price is a good thing.

Sincerely,

Geoff MacDonald

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