

Written by Geoff MacDonald

Is There News in Good News?

- Frogs Thought to be Extinct Found After Decades
- General Mills Reverses Palm Oil Policy, Saves Rainforest
- Endangered Florida Panthers Making a Comeback
- Woman Leads Town to Lose 15,000 Pounds
- Cancer Survivor Plants Sunflower Field
- How to Survive When Your Elevator Plunges
- NC Insurance Giant to Refund Millions to Customers Due to Health Care Law
- 100 Million Poor Families to Get Clean-Burning Stoves From Mrs. Clinton
- Kohl's Stores Reach Milestone With 100th Solar Location
- Grand Banks Cod Stocks Grow 69% Since 2007
- U.S. Government Leads the Way Cutting Greenhouse Gases

I grabbed the headlines above from a website called the GoodNewsNetwork.org. The website is a news network dedicated solely to reporting good news. The founder and editor of the website started the network in 1997 with a goal to “make this a business” and to prove that “good news sells”. It’s a novel idea, but when I read the headlines, there were only 10 members on line reading the stories and no advertising to be found anywhere on the website. Because the network only reports good news, you’ve probably never heard of them before. I certainly hadn’t.

As many of you have probably noticed, the headlines in the financial media today appear to be void of any good news stories. Perhaps the media empires, driven by profit, understand that good news doesn’t sell.

The negative financial news that makes the headlines is actually great news for the wise long-term investor. When purchasing a stock, getting the entry price right is one of the most important factors in generating strong long-term returns. Getting the entry price right is much easier when the seller is manically depressed or fearful about the future. The media’s distorted attention on the negatives will help us generate strong long-term returns for our investment partners.

Since EdgePoint Wealth’s launch in November 2008, we’ve been saying that given the headwinds in the economy one should assume that “things could be slower for longer”. But even in an environment with economic headwinds, there are businesses that will continue to prosper. It’s those businesses that will grow in the face of current headwinds that are our focus. They are our focus because the fear in the marketplace assumes few, if any, businesses will grow.

In this commentary, I’d like to illustrate that there are many positive developments in the companies we own. While these developments may not be readily apparent when you look at their stock prices, they are evident if you dig into the businesses’ operating performance. Their continued operational success should eventually be reflected in their stock prices.

Before doing so, I'd like to highlight a story from the Financial Times last week. The article discussed how the U.S. is experiencing its strongest recovery in 25 years. Because the Financial Times would stop selling papers if everything was great in the world, this particular story was buried deep on page 22.

The article highlighted the fact that the first year of this current economic recovery has proven to be stronger than both of the previous two recoveries in the past 25 years. Specifically:

- Real gross domestic product (GDP) growth has been greater than the first year of recovery in both 1991 and 2001
- In the first 14 months of the current recovery, 205,000 jobs have been lost. This compares with 220,000 and 935,000 cumulative jobs losses respectively at the same points in the 1991 and 2001 recoveries
- Corporate profits have already recovered to the all-time record highs of the last recovery – one of the fastest profit recoveries in the post-war era

We're not cheerleaders for the economy or the stock market. But to the author's point in this article buried on page 22, "should the strongest recovery in 25 years be widely considered the worst ever?"

I'll ask the question I asked at the beginning of this commentary, "is there news in good news"?

Let's Talk About Our Businesses

Cisco Systems Inc.

On August 11, Cisco reported its fourth quarter earnings. Sales were up 27%. Earnings for the full year were 19% above the same period last year. There are nine areas of communication in which Cisco competes, and Cisco is number one in each of these areas. We like to say that Cisco is building the plumbing to the internet. Our fears about the future or a slowdown in the economy will not stop the need to continue to build out that plumbing, and Cisco will be the prime beneficiary of that build.

Cisco's management team has stated on many occasions that they believe Cisco can grow by at least 12% to 17% per year for the next several years as they continue to build out the plumbing to the internet. In actual fact, they have been growing at a much faster pace for the past few quarters.

During the year, Cisco repurchased \$7.8 billion dollars in stock! They repurchased these shares from sellers who sold their holdings on concerns about the broader economy: Greece, Spain, Ireland, government deficits, inflation, deflation, the possibility of a double dip recession, etc.

Cisco has performed strongly during the past year, yet its stock is down 11% year-to-date. While stock prices and business fundamentals do not move in lock-step in the short term, we expect Cisco's stock price to reflect Cisco's growing fundamentals over the long term.

WellPoint Inc.

On July 28, WellPoint announced its second-quarter results. Earnings were higher by 11.3% over the same period last year.

We've talked about WellPoint in previous commentaries. It's hard to find a company in any industry that has the type of strong competitive advantages that WellPoint has in its industry. In addition to having a dominant competitive position that allows it to continue to steal market share from weaker competitors, WellPoint has the wind at its back as it benefits from industry growth – an industry that grows in line with healthcare spending, which is heading in only one direction.

During the first six months of this year, WellPoint repurchased \$2.9 billion in shares from sellers who got nervous from negative press clippings. The company also announced its intention to repurchase another \$1 billion in shares subject to its ability to find additional investors willing to ignore the company's future growth prospects.

WellPoint's business performed very well during the past year, yet its stock is down 4% year-to-date. Again, short-term moves in the stock market rarely correlate with business fundamentals, but over the long term, it's the business fundamentals that drive value.

International Rectifier Corp.

On August 26, International Rectifier announced its results for the fourth quarter. Revenue was higher by 65% from the fourth quarter last year. Company management stated that design win activity remains strong and they continue to see increased end-market demand for their products.

Though there will always be some cyclical in this business, we believe the demand for increased energy-efficient electronics will continue to grow, even if the global economy faces headwinds, and International Rectifier will be the primary beneficiary of this trend.

The company repurchased 435,954 shares during the quarter and we'd expect it to be even more aggressive with its share repurchases in the coming year if the market continues to ignore International Rectifier's growth potential.

The stock is down 4% from the start of the year.

Team Inc.

In August, Team announced its fourth-quarter results. Sales were higher by 4% and earnings increased by 10% from the same quarter last year. Team has experienced sales and earnings growth of 20% and 19% per year respectively since 2001 even with a set back during the past 18 months caused by the recent recession.

Team is the industry-leading provider of maintenance and installation services for pressurized piping systems and process inspections of industrial plants. Its customers include anyone who has pressurized piping systems. 85% of Team's revenue is related to maintenance activities and their services are required for up-time and safe operations. In other words, the services they provide are not discretionary.

Plants with pressurized pipes undergo hydraulic, thermal, or corrosive stresses which degrade the piping systems overtime. These stresses will continue to drive demand for Team's maintenance and inspection

services, even if Greece defaults on its debts. I'd even be willing to bet that neither inflation, deflation, nor a slower-than-expected economy will impact these stresses on these pressurized pipes.

We expect substantial margin improvement in the coming years and additional revenue growth as Team continues to grow its market share at the expense of small "moms and pops".

The company announced its intention to buy back up to 5% of its stock in August 2010. Team's stock price is down 6% from the start of the year.

Plenty of Positive Developments

The four companies discussed in this commentary have experienced share price declines this year. These declines would likely be the negative news stories that the popular press would have had a field day with, causing you, the investor in these businesses, grief as you read the stories. Dig a little deeper and you'll see plenty of good news brewing within these companies. These positive developments aren't reflected in their stock prices yet this year, but if history is a guide, business fundamentals always win over the long term.

Fixed Income Comments

The macro-economic uncertainty that has contributed to the equity volatility has created interesting opportunities in corporate bonds this quarter. Corporate spreads widened this quarter pushing U.S. corporate bond spreads wider by 10 to 30 basis points (one basis point is equivalent to 0.01%) across the yield curve this year.

This uncertainty has enabled us to find several attractively-priced convertible bond issues that not only provide attractive yields but offer the opportunity to participate in any upward movement in stock prices. In the meantime, we are comfortable owners of the bond, while receiving a coupon (interest) payment.

Kinetic Concept's convertible bond, which matures in 2015 was purchased with a yield of 4.24%, or 300 basis points over U.S. government bonds with a similar maturity. Kinetic Concepts is the leading provider of wound care therapy and there is a great opportunity for the company to expand the application of their technology as well as increase international sales. We like the fundamentals of Kinetic Concept's medical technology business and believe it could grow significantly over the next five years. This bond issue allows us to participate in the success of the business while still paying us a coupon.

The size of the Canadian dollar high-yield bond market in Canada has grown throughout 2010, with approximately one new issue each month. We have selectively participated in a number of new bond issues whose underlying business fundamentals we feel are strong and the company is able to generate substantial free cash flow.

Corus Entertainment Inc. issued 7-year debt in February of this year with a coupon of 7.25% and a spread of 445 basis points over Government of Canada bonds. Corus is a leading Canadian media and entertainment company that has a strong presence in specialty TV channels, radio and content development. The company owns powerful brands and is run by a conservative management team that has generated solid returns and is committed to having a clean balance sheet free of high levels of debt. We purchased Corus bonds through the new issue process and increased our initial position by purchasing

additional bonds in the secondary market. While the bonds have risen in price from their initial price of \$100 to \$106 at the end of September, we continue to own these bonds which pay a relatively high coupon.

Corporate bonds continue to represent 100% of the bond component of the portfolio.

Sincerely,

Geoff

Commentary as at September 30, 2010. The above companies are selected for illustrative purposes and are not intended to provide investment advice. EdgePoint Investment Group Inc. may be buying or selling positions in the above securities.

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Published October 5, 2010