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VALUE INVESTING IN THE INTERNET ERA

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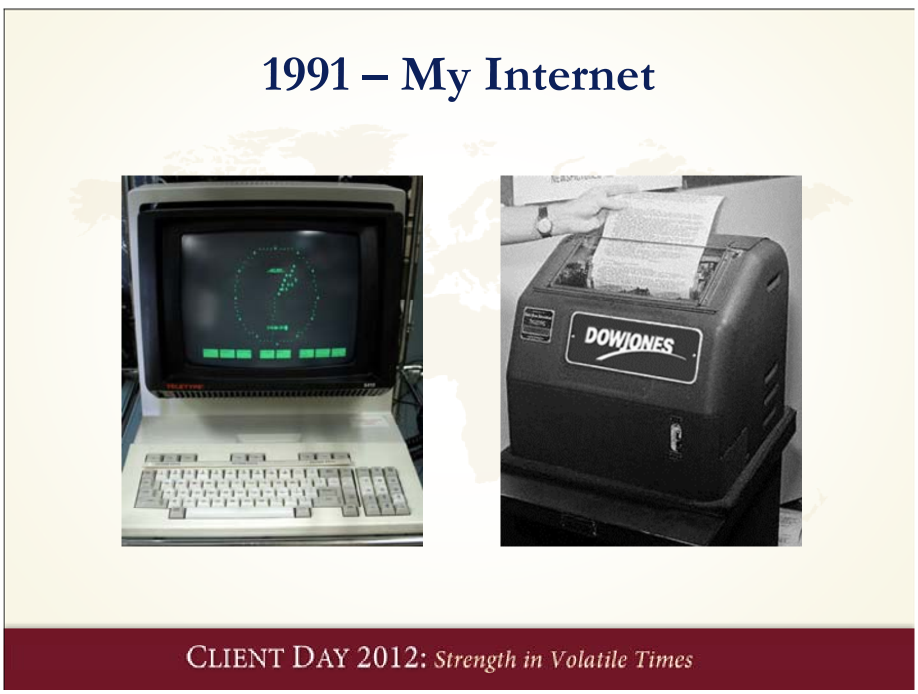
Allan MacDonald delivered the following speech on May 9, 2012 at the Burgundy Toronto Client Day

One of the things that we're finding affecting us today is the use of the Internet and how it has changed the way we invest. So I thought I'd take you back to when I started in the business 21 years ago in 1991: what the challenges and the opportunities were then versus today.



So back in 1991, this was my Internet domain. On the left you can see that large screen there, and that basically gave you quotes on stocks. That was all it did; it had no other utility. It took up a lot of real estate on your desk.

One thing it did do, though, was it would identify when there was a news item on a specific stock, and with that information and knowing the time that the news item would go, you'd walk over to the one on the right, called the Dow Jones Newswire. The Dow Jones Newswire would have a continuous printing function, so it would be printing all day long, spewing out paper on the floor and you'd walk up there and you'd look at the time and you'd try to get to your news item. That's how you got news 21 years ago in this business. And usually the news, as you can imagine, was not very in depth. In most cases, if it was earnings, you'd get revenues – year over year and net earnings – and that was the extent of the detail. This was supposed to be market-moving news so you had a very interesting sort of information deficit.

So 21 years ago, how did we get information? Well, when you were interested in a stock, you would phone the company, try to track down someone in investor relations, probably leave them a message and hope they get it. Then, two weeks later, they might send you the information or they might not – you never really knew, but that is how you got information in that day.

So to summarize, company information was extremely hard to come by, the information was usually not very good, there were seas of companies that were not getting any research coverage at all, especially in the small-cap world, and there was just this huge deficit of information. In other words, it was a great time to be an investor because the information deficit meant there were hundreds, even thousands, of mispriced securities – literally seas of undervalued stocks to choose from.

I just want to highlight a couple of anomalies that I found when I was early on in this business. Onex and Goldfarb are two companies that I had some history with. Now some of you may know of these companies or may have heard of certain management, especially Martin Goldfarb, and you might question my corporate governance criteria at the time, but I must admit it wasn't high on my list; it's a much higher priority now but, nonetheless, they were cheap stocks. And I'll give you some examples: Onex Corporation had a market capitalization of $100 million. As some of you know, Onex buys companies, uses leverage on the individual companies and sells them, usually for a profit – and they've done a pretty good job.

What was interesting about it back in 1991 was that it was a much-hated stock – $100 million just sitting in its corporate account unencumbered. The whole market capitalization of the company equalled about $100 million, so what you inherited for effectively nothing was seven companies – everything from auto parts to dairies – that had $2.2 billion in revenues – a staggering sort of difference between the market cap and that revenue stream.

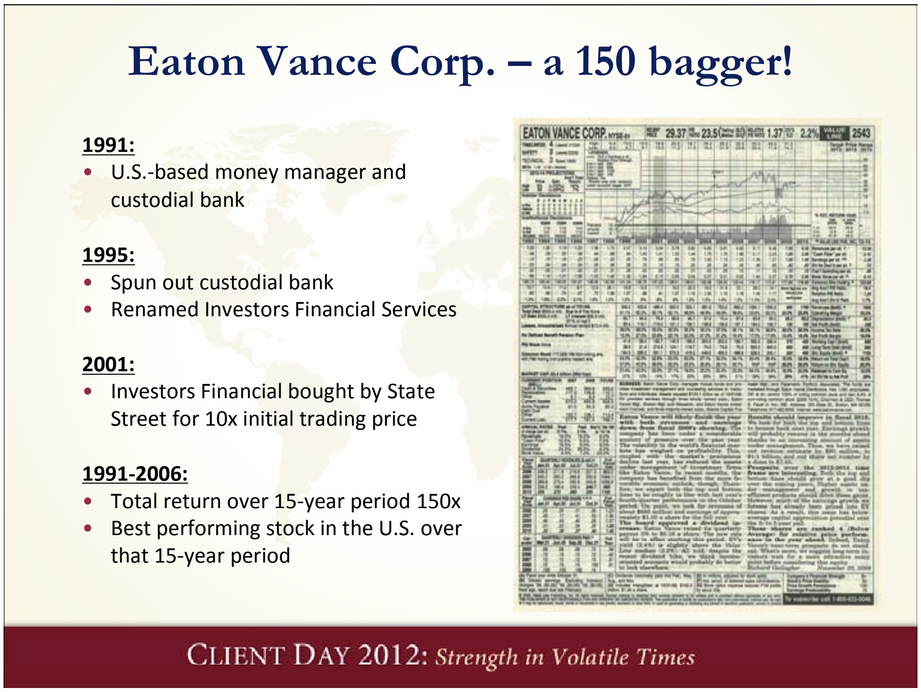
And the interesting thing about that is yes, there was leverage at those seven companies, but they were all in separate silos so, even if one went under, it wouldn't affect the others. So, even if six of the seven companies went under, you'd still make money on this stock, theoretically. As it turns out, six of the seven companies did extremely well; one was marginal and the stock obviously went up dramatically. That market capitalization today is $4 billion and there's been a significant amount of dividends along the way.

The other stock that I had some history with, which I found fascinating, was this tiny firm called Goldfarb Corp. It was in the market research business and, at the time, it was generating normalized earnings of about $4 million from operations. The earnings had come off during the recession of 1991, but were building back up. So for $5 million, you got a business generating roughly $20 million in revenue and earning $4 million, but what was sort of hidden about it (that the market never picked up and it would be one of those things that I don't think you could find today) is that it owned 35 per cent of a company called Speedy Muffler. At the time, Speedy was actually a thriving business; it's subsequently done very poorly and actually gone bankrupt but, at the time, it was actually doing well.

Nobody seemed to really know this and, even though there were rumours about Speedy going public, nobody connected the dots here. When Speedy finally went public, Goldfarb owned $70 million worth of Speedy stock.

You can see the pretty compelling market that we lived in at the time. You never appreciated it in the moment, but thinking back, I think of the things I could have done over again.

We talk about stocks – trying to buy a dollar for $0.60. Well, we were buying a dollar for $0.10 back then, or at least some people were – that's how crazy that time was. A wise man once said, "Only liars and fools like competition" – and back then there just wasn't the competition that we have today for investment ideas.

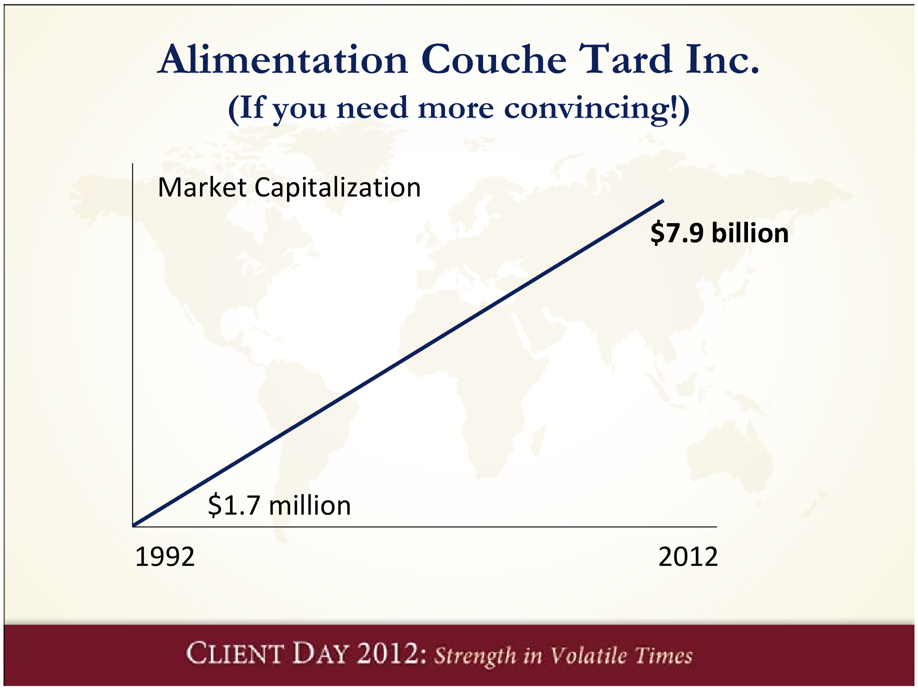


Moving forward, sort of the granddaddy of them all: how did you find information in an era where there was no electronic information? I used to scan the Value Line books, which is shown on the right of the slide. As you can see, it would give a snapshot of data, it would give you a snapshot of the balance sheet, a little bit of history and what not – that was probably the most effective way at the time, and even today it's still an effective way to generate some stock ideas.

I stumbled across Eaton Vance Corp. – here's a guy from Vancouver, he's been in the business six months and he stumbled across this company – I didn't know much about asset management, but it was pretty obvious it was quite profitable. In addition to being a money manager, it had a custodial bank, which was actually a very good business when done right, and the combination of the two sort of made the balance sheet very opaque. So the combination made it difficult to analyze, but once you pieced through it, you realized that with the investments they had in some timber partnerships and some other investments, you were paying about one times earnings for this company back in 1991.

And it went on to be the best-performing stock over the next 15 years, going up roughly 150 per cent if you added the two businesses combined because, in 1975, they spun off the custodial business, which went up tenfold in its own right before being bought. I don't think that today some guy with six months of experience just flipping through this could find these types of things. I think these things are probably arbitraged away forever. I, in some ways, got lucky to be the last person in when the markets were truly inefficient, but it does show you.

Now you're probably going to ask – what did I do with all this great knowledge? Well, I was managing as close to zero money as possible, so unfortunately a lot of it went to waste. But it did get me into the business, so I appreciate that.



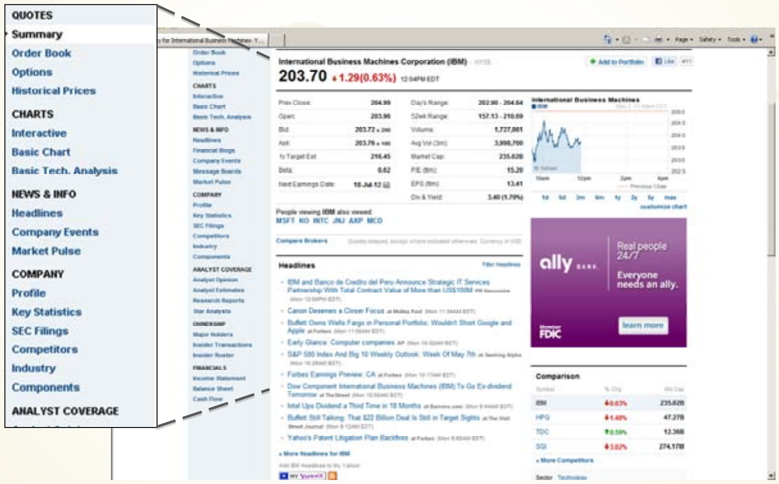
I just wanted to throw another slide up here in case you had any doubt about the cheapness of that era – this is a company that's in the news today. It's the largest convenience store in the world now. They just did a $2 billion deal in Scandinavia but back then it was a convenience store based in Quebec. You know, I didn't look at it back then; I had no history at this, I looked at it once – I thought selling cigarettes and gasoline must be a terrible business.

But, for $1.7 million, if you could have somehow convinced management to sell you the company for that all-time-low price (admittedly not a likely scenario), you would be, I think, 110 on the *Forbes* list of billionaires today. It just shows the extremeness of that moment in time that we may never see again.

Going forward, what is it like today? Professional managers have tools that we couldn't have dreamed of 20 years ago, even 15 years ago or 10 years ago. The amount of data that we have access to and the way we can manipulate it and the way we can search it and what not is extraordinary. We're doing a search today to replace our information services firm wide and one of the leading candidates is Bloomberg – and it's just staggering what they can do with information today.

So professionals have a huge advantage – a huge tool that they didn't have before and I'll give you a statistic. In 1992, Bloomberg had 20,000 terminals; today they have 350,000, so there are a lot of people out there looking for anomalies in the market. You've got PhDs who, in other eras, might have worked at NASA – they're getting paid millions of dollars at hedge funds to look for trading anomalies. It's very frustrating on that front to put an order in and see someone seemingly always jump in front of you. You've got people looking for fundamental sort of information, so it's just a touch tougher.

Today – Individual Users



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On top of that, you've got the amateur or individual investor that has tools that you wouldn't have dreamed about – so something like Yahoo Finance for the cost of zero will get you SEC filings, multi-year financials, analyst recommendations, screening tools, historical pricing. All for free, all over the world – the world has become flat.

On top of having all these professionals competing with you, now you've got some kid in Sri Lanka with 180 IQ who has gone to Yahoo Finance looking for undervalued stocks and who is making my life miserable, but it's probably a good thing for the world, I'd imagine.

Spin Offs

- Forced selling from both institutional and index shareholders
- No pre-trade marketing or road shows
- Limited to no research coverage
- Often no obvious comparables
- Management equity incentives encourage a low stock price

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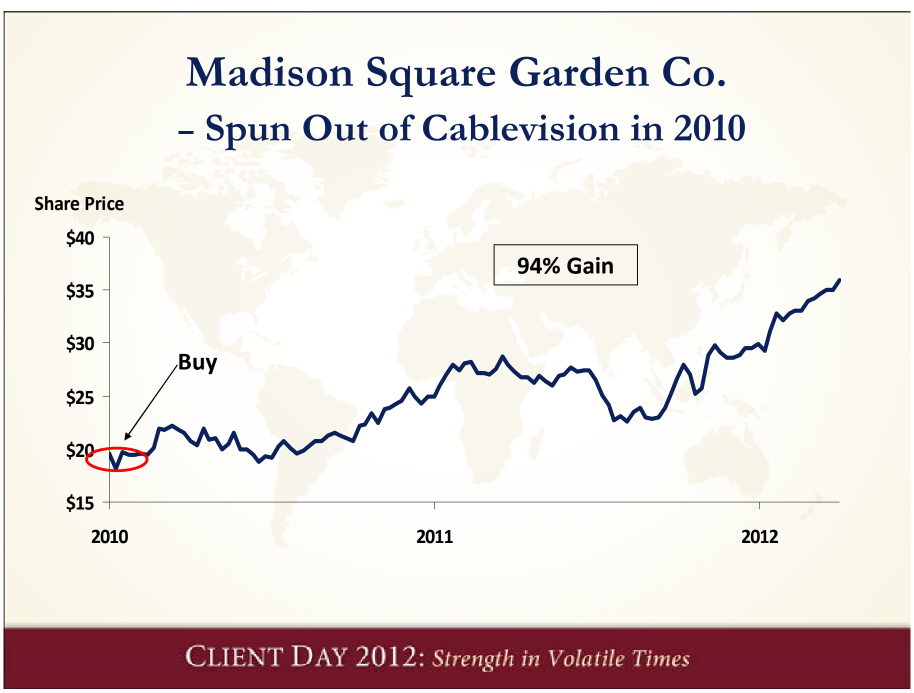
So where do you find value in a market that has sort of a perfect information flow? One of the areas that has been interesting for us, and we hope continues to be so, is the spin-out. The spin-out is basically when one company decides to carve out a piece of their business as a public entity in the market. Unlike an IPO, the spin-out is when the stock is basically given to existing shareholders. There is no road show per se, there is no marketing around it and there's limited or no research coverage. One of the bigger things often in this case is there will be no direct comparison, which we think is very interesting because you don't have a lot of things to value it against.

The other big thing that we like is that management's equity incentives encourage you to keep the stock low because when they spin it out, most of their equity incentives would be based on the opening price, so there's no reason they'd want a stock to go out at 15 when they can do it at 10. The largest one – and this is true of any asset anywhere – is when you have forced selling. You have people that just don't care – this is a great place to look for value ideas. In this case, you have two forces at work in your favour. One is that you've got money managers that will inherit a stub position – might be 10 basis points or 15 basis points. They don't want to research it, they don't want to know anything about it, it's not going to drive their performance; it's probably too small if you're a large-cap manager and they just punt it at whatever price.

A big part of the market today is indexing and it is when they get a spin-out, and inevitably just sell into the market at whatever price they can get because they don't really care; it's not part of the index anymore, it's not eligible for the index. So we think it's a really interesting, great place to be – and it's actually been quite a lucrative place to be.

So I'm going to show three companies here quickly and I'll just talk about them briefly.

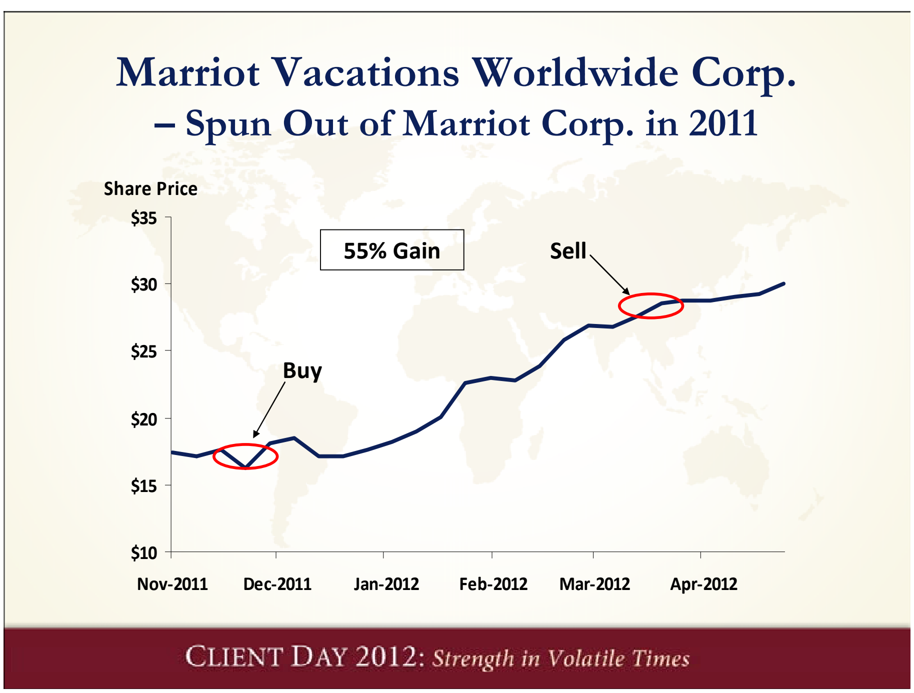


Madison Square Garden is obviously an iconic name in the sports world. It owns Madison Square Garden in New York and the New York Knicks and Rangers, but the real jewel of this company is that it owns the MSG Network, which is a regional sports network with more than eight million subscriptions, or subs. They get an astounding $4 per sub per month for their programming – an incredible amount. So before they even turn the lights on every year, they know they're going to get roughly $400 million in revenue. It's a jewel of an asset. It generates almost $200 million of earnings. This is a company that the market didn't really like when it first came out and there are a couple of reasons for that.

One is there's no comparison; there's nothing you can point to and say, "There's the valuation." Having said that, if you used the valuation that Maple Leaf Sports got when it sold to Rogers and Bell, the stock, instead of being $18, would have been $50. But that comparison wasn't available at the time – thank goodness.

And the other thing the market didn't like is the company had intentions to spend $800 million to renovate its arena – I mean, $800 million to renovate a building – the market just looked at that as sort of throwing money away. Like, you might as well just flush it down the toilet. But the reality is if you thought about it, there were huge revenue opportunities (for example, more luxury boxes and enhanced seating). So in the middle of this renovation, MSG announced with great fanfare some winning teams, finally, and that they were going to increase ticket prices 49 per cent. It stuck; a lot of complaining, but they still have as many season tickets as they had before.

So a great franchise at a very depressed price, misunderstood by the market. Now you've got a lot more positive research on it and you see the stock move. It's probably a bit pricey at this point. It's a big position for us, and we may be trimming it so I warn you. It's had a fairly large move from $18 to $36, but an interesting company.



Another is Marriott Vacations. Marriott was spun out of Marriott Corp., the large hotel company. Marriott Vacations is in the timeshare business. The timeshare business is not a widely understood business; it's perceived to be a lousy business. I should say that my friend and partner Steve Boutin found this for us and shepherded it right through to our sale. It could be difficult accounting to understand because there's some gain of sale in it, but the thing about it is nobody wanted this stock when it came out. The tangible book value of this stock was $35 and it traded for $18.

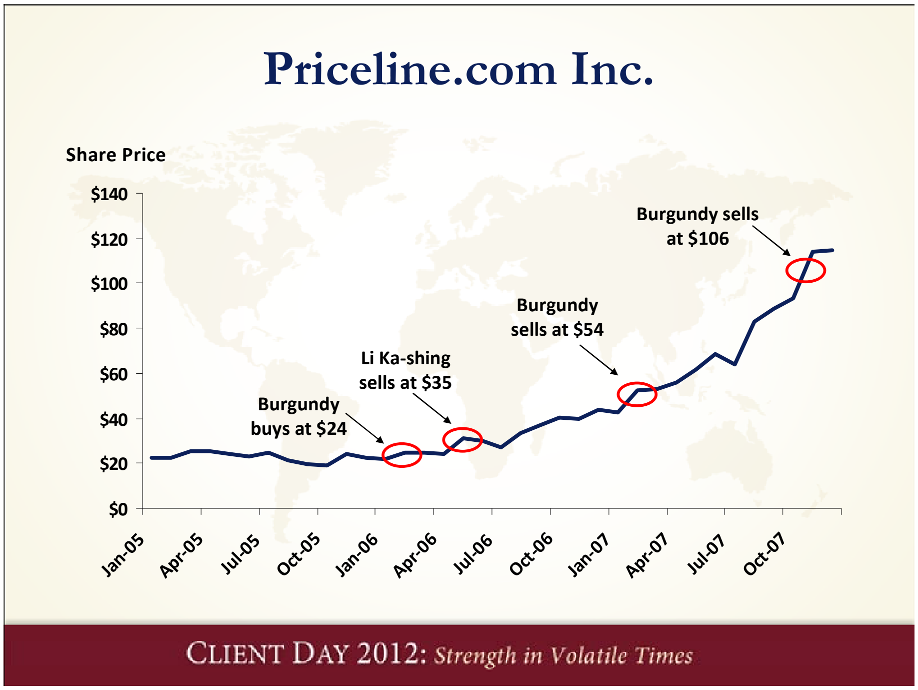
In real estate, tangible book value matters, but it is misunderstood, so we were able to buy it very cheaply. There have been some positive thoughts about the economy, and even the real estate market is coming back. In a way, this was a play on distressed real estate and the stock moved up to $27 and we sold it. Now, I know we preach long-term, buy-and-hold investing, but I can tell you that instant gratification is highly agreeable.

So the final one of these spins is TripAdvisor, which is a company that is sort of the other side of the spin – where you own the stock already, which was Expedia (which we've talked about); Expedia itself was a spin-out of another company in 2005. We got a share of TripAdvisor. We got, actually, one share for every two shares we owned of Expedia. TripAdvisor had been a classic case where a high-multiple stock was trapped inside a low-multiple company. In freeing it up, you get the multiple lift relatively quickly.

TripAdvisor has great long-term prospects, great growth. I should go back and say that TripAdvisor – some of you have used it – is an Internet business that helps aggregate reviews on hotels and restaurants and other things; it's a great business model. When you think about it, you've got all the content for free because everybody writes a review for no compensation and you get to resell it back to advertisers and people that can use the click through. It's done very well since it's come out.

It came out at $2 and is in the $40s now. Unfortunately, the valuation has gotten to the point that we have sold it. And to give you an example, we estimated that there was almost no value given to this stock inside Expedia three years ago. Today it's got a valuation of $5 billion; it's actually exceeding all of the other part of Expedia's valuation today.

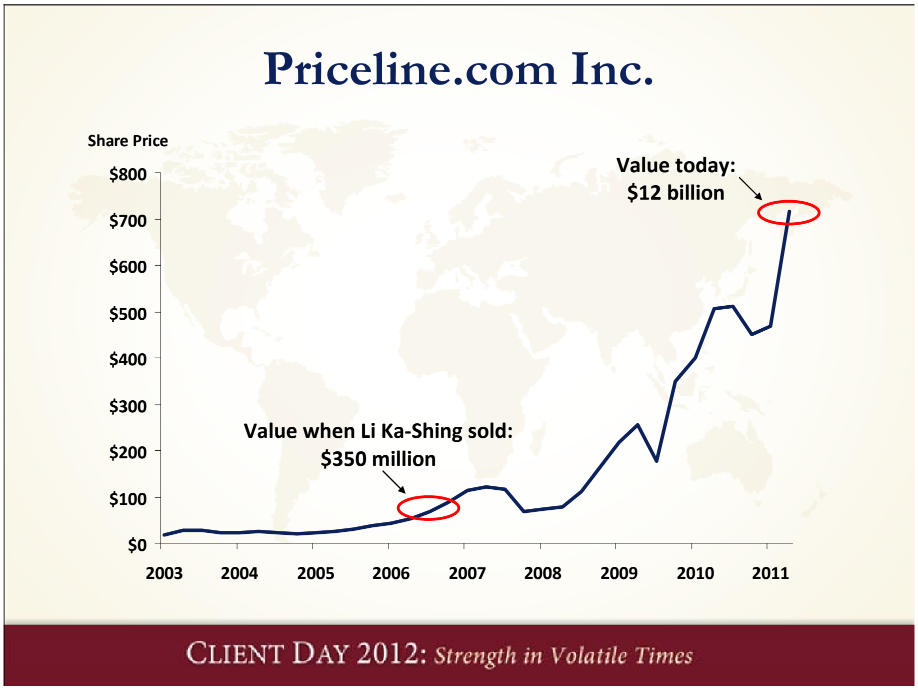
And lastly, I'm sure a lot of you know who this person is – a hugely respected investor in Asia. Extremely rich, smart but even he can have his frustrating moments in this humbling sport called investing. You know there's not much that we have in common as you can tell, but there's one thing we do: we both shudder when we hear the name Priceline.



We bought Priceline, as you can see there, in February 2006 for $24. Priceline is a phenomenal business. It's in the online travel business like Expedia is. It's actually been an area where we've made a lot of money over the years. It's a hugely lucrative international business, with Booking.com as one of its brands.

It's a great business in that it's very capital light – it generates copious amounts of free cash flow. Priceline has been, you can imagine, very successful. So we bought it at $24, and shortly thereafter, Li Ka-shing – he owned a third of the company and had two seats on the board – sold his entire share for $35. So we're sitting there thinking, "Wow, what does he know that we don't know?"

The financial performance of the company was astounding. I should have actually brought a chart to show you some of the growth and income and operating margins. It just kept powering along – we just couldn't take it at $50 – so we sold a chunk. And at $106 we said, "You know, it's crazy: if he's selling at $35, what are we doing hanging around at $100?"



So anyways, fast forward and I call it the $11-billion miss – and that's even significant money for *him*. So $350 million he received on the sale; I'm guessing he made about $100 million. Today, the value of that would be $12 billion. So this business humbles just about everybody at some point in their career.

Now, if we had kept our price on position, which clearly would have been the right strategy, this would have been the Small Cap Fund ownership structure today.

So I guess you can't win them all.

Thank you.