The VIEW *from* BURGUNDY

A Quarter-century of Investing

SECOND EDITION

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Foreword

When we started Burgundy, we had two main goals: to focus on earning long-term absolute returns for our clients (without taking excessive risks), and to look after our clients extremely well. These two goals may sound simple, but they are not simple to achieve. In fact, many investment firms fall well short of these goals because they focus on short-term relative results and too often take clients for granted.

Our investment approach embodies a long-term view. We invest in good companies when we can buy them for less than they are worth. Then we wait for the market to recognize the value of these companies. We try to invest in companies that have the ability to compound their value over time so that the investments grow accordingly. It takes time and patience; more importantly, it takes original, intensive research to identify companies with strong investment potential. We have always made our investment decisions this way and we will continue to follow this investment path in the future.

Over the past 25 years, we've shared our thinking on important business and investment topics with clients through our newsletter, *The View from Burgundy*. We've covered a range of topics, from specific companies to overall economic policy and external factors that affect the growth and progress of companies. We've examined issues affecting investors and advocated on behalf of investors. We've also debunked conventional thinking and explored contrarian positions that are irksome to parties stuck on mainstream thinking. *The View* has often been provocative in nature.

The View has been a critical part of our client discourse and relations. I cannot count the number of times that clients have referred to or called me about a specific issue or topic. I know that issues of *The View* are often cited in corporate boardrooms. It's gratifying to know that the information is useful, provoking discussion and conversation with our clients and industry leaders around the world.

I am proud to introduce the second edition compilation of *The View from Burgundy*, going back to 1993. The second edition is an update of our original compilation, published in 2007, and includes 14 additional issues of *The View* up to the end of 2016. Our style of writing has evolved over the years, but our investment philosophy has remained constant over a quarter-century. By consistently adhering to this philosophy, we continue to hold those same goals set 25 years ago, and remain focused first and foremost on you, our clients.

Yours truly,

Tony Arrell

Tony Arrell,
Chairman and Chief Executive Officer

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Introduction

Burgundy's preoccupations over the period from the global financial crisis until the present fell into some familiar categories, but also went off in some new directions. Familiar themes included: capital allocation (*Growth That Matters*); international investing (*Great Walls, Wide Moats & Red Flags; Is Japan Our Future?*); management compensation (*Top Quartile*); and controversial transactions (*Not the Time to Sell*).

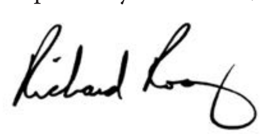
We continued to turn our attention to the challenge of how to make good decisions in the capital markets, a long-standing preoccupation of our portfolio managers (*The Most Valuable Option of All; An Investment Lesson from Warren Buffett; Stoicism and the Art of Portfolio Intervention; Ain't Misbehavin'*).

In a couple of one-offs, we gave some advice to clients on how to view the business evolution of their money managers, with warning signs that they were getting off track (*Surviving Success*), and attempted to show how quality-value investing can trace its pedigree to Benjamin Graham, the patriarch of value investors (*Confessions of a Buffetteer*). To wrap things up, we outlined the great value of visiting businesses and interviewing management (*Boots on the Ground*) and came back to the fundamental goal of investing with a margin of safety (*Winning by Not Losing*).

Our goal, as always, has been to put our principles and practices in print so that we can be held accountable for applying them, and also so that we can inform and interact with our clients. Burgundy's clients continue to be our best "quality control" and we deeply appreciate the conversations we have with them on investing matters.

We hope that *The View from Burgundy* compilation can be read with profit by a new generation of investors.

Respectfully submitted,



Richard E. Rooney,
President and Chief Investment Officer

1990 – 1994

1991
Breakup of Soviet Union

1994
Russian economic collapse

Web browser, Netscape Navigator, becomes freely downloadable

1990
Savings & Loan Crisis

1993
European Union formed

April 1993

The Outside Zebras

John Train, in his outstanding book, *The Money Masters*, relays the following story in his chapter on Ralph Wanger. Wanger, as manager of the well-known Acorn Fund, is a famous investor, and is obviously a very talented writer.

> Zebras have the same problem as institutional portfolio managers. First, both seek profits. For portfolio managers, above average performance; for zebras, fresh grass. Secondly, both dislike risk. Portfolio managers can get fired; zebras can get eaten by lions.
>
> Third, both move in herds. They look alike, think alike and stick close together. If you are a zebra, and live in a herd, the key decision you have to make is where to stand in relation to the herd. When you think that conditions are safe, the outside of the herd is the best, for there the grass is fresh, while those in the middle see only grass which is half-eaten or trampled down. The aggressive zebras, on the outside of the herd, eat much better.
>
> On the other hand – or other hoof – there comes a time when lions approach. The outside zebras end up as lion lunch, and the skinny zebras in the middle of the pack may eat less well but they are still alive.
>
> A portfolio manager for an institution such as a bank trust department cannot afford to be an Outside Zebra. For him, the optimal strategy is simple: stay in the centre of the herd at all times. As long as he continues to buy the popular stocks… he cannot be faulted. To quote one portfolio manager, 'It really doesn't matter a lot to me what happens to Johnson & Johnson as long as everyone has it all together.' But on the other hand, he cannot afford to try for large gains on unfamiliar stocks which would leave him open to criticism if the idea fails.

> Needless to say, this Inside Zebra philosophy doesn't appeal to us as long-term investors.
>
> We have all tried to be Outside Zebras most of the time, and there are plenty of claw marks on us.[1]

The Value Investor as an Outside Zebra

We think Ralph Wanger's story has an important message for value investors. True value investors buy only when a stock is too cheap, and sell when the market price is too expensive compared to the true intrinsic value of the company.

While value investing is a style of investing that a fair number of professionals talk about, in our opinion there are very few who practice it successfully. The reason is that, like the Outside Zebra, being a value investor is often an uncomfortable position to be in. It requires the willingness to do what is unpopular and the discipline to stick with your decision while the majority of investors are going in a different direction.

At Burgundy, we are entirely committed to value investing. Doing it successfully is, we believe, our greatest strength.

Value in Canadian Equities

There is a great start to 1993 as the Burgundy Canadian Equity Fund returned 19.9% compared to 8.3% for the TSE 300 Index. While one swallow does not make a summer, it is nice to score a few runs early on in the ballgame. This extends the record of outperformance relative to the Index dating from 1981 by the Fund's manager, John Di Tomasso.

Our "bottom-up" value investing approach is so-called because our focus and analysis is directed towards the purchase and sale of specific investments. This technique is especially pertinent to stock selection. We are the other end of the spectrum from the "top-down" approach – which is an attempt to understand and determine the implications of the big picture (global macroeconomic factors such as interest rates, currencies, etc.). This overview then works its way down through the Canadian economy and various industry groups, and eventually assesses individual securities within those broader contexts.

The top-down method is comprehensive – too comprehensive, actually. There is simply more information (which changes by the minute, incidentally) than any person or group of persons can assimilate and properly integrate into a world view designed to produce successful investment decisions. Given the millions of factors that must be identified, understood and correctly placed within a dynamic context, the job requires superhuman effort and ability.

At Burgundy, we recognize that weighty matters like GNP growth, future interest rates and the monetary policy of central banks affect securities markets in a major way. And sure, it's fun to play armchair economist with the boys over a cognac or two, yet even then it is difficult to get a consensus, let alone a confident conclusion. So, in our experience, the end result of all this work is economic forecasts that have little predictive value where it counts: investment results.

We have found that it is better to focus our efforts on the valuation of individual companies, particularly on the calculation of intrinsic value, and the comparison of intrinsic value to market price.

However, after this disclaimer regarding macroeconomic analysis, it is our general view that we are in a recovering economy, if only in a slow way. Canada has had three very grim years and we feel that some factors are now improving. It should be remembered that Canada is basically a very rich country. Significant restructuring of companies, closing inefficient operations, increasing productivity and paying attention (at last!) to international competitiveness have all been going on in a major way for several years. While painful, these steps should lead to a stronger base and eventually a more prosperous corporate Canada.

Most important of all is that some good companies are available at very reasonable prices in comparison to Burgundy's estimate of the company's intrinsic value. These bargain companies appear in various areas of the economy, but, in our opinion, they are at the moment particularly prevalent in the industrial (St. Lawrence Cement, Dofasco) and financial sectors (TD Bank, National Trust). The opportunities are less common now than a year ago; the stock market has gradually increased in price and is an average of 9% higher than it was then.

It goes without saying that a stock should be sold when it becomes fully priced. Sometimes, however, a particular stock (for any number of reasons) will become the darling of the street and gain momentum, or an industry will capture the imaginations (and the pens) of brokerage analysts. At such times, even though our targeted price might have been reached, we might hold onto the entire position, or sell only a part of it, in order to let the market carry the stock higher. This is not our usual practice, mind you, since it presumes that this overpriced security will become even more overpriced – the greater fool theory. True, market prices do fluctuate between extremes of over- and undervaluation, but one must recognize that holding an overpriced stock implies, from that point, a greater price risk than the potential reward.

Although we are still able to find enough Canadian opportunities to efficiently diversify our portfolios, they are becoming fewer and we may set aside cash reserves as targeted sales take place.

Value in the U.S. is Harder to Find

We are finding it difficult to identify bargains in the United States as stocks overall are being valued at much higher levels than in Canada. Nevertheless, we have established positions in a few new American companies that we judge to be of outstanding value.

An example is Loews Corp. (NYSE $98) following its recent sharp decline. We believe that Loews is an excellent example of a good company that is very significantly undervalued. The key reasons follow:

- Loews is run by a great investor and businessman, Larry Tisch. There is no doubt that Tisch is one of the great investors of our day and someone we have admired for many years. John Train's *The Money Masters* contains a full chapter on Mr. Tisch, who is ably assisted in his endeavours at Loews by several relatives including Jim Tisch, his son. Insiders own 26% of the stock.
- Over the past 10 years, book value per share has grown from $16.92 in 1982 to $84.10 in 1992, which, coupled with dividends, means shareholders have had a return of 20.7% per annum over the decade.
- Loews is in casualty insurance (control of CNA Insurance), tobacco (Lorillard), Loews Hotels, Bulova Watches and CBS Television. Through CNA, Loews has a very large securities portfolio, and also a large corporate portfolio.
- The company has an excellent financial record with 10-year return on equity averaging over 15%, and an even better record of building shareholders' value since Loews had been constantly buying back its own stock for many years. This is clearly a company exhibiting canny capital allocation skills, using excess cash flow to buy back its own undervalued stock and creating value on a very tax efficient basis for its shareholders.
- The loss in 1992 reflects the establishment of a $1.5 billion reserve at CNA for asbestos suits.
- The current share price is $98. If the book value is adjusted to market for its CNA shares (it is a public company on its own) and availing Lorillard at 10 times pre-tax earnings, Loews is worth $195 per share or twice the current price.
- The current price of $98 compares to recent analyst estimates of $11 per share for a PE ratio of 8.9 times.

Author: **Tony Arrell, Chairman and Chief Executive Officer**

July 1993

The Money Masters

The Money Masters, by John Train, is one of the greatest books that we know of on how money is really made. Train is a successful money manager in his own right and an investor of some note. We have recommended this book for years to friends and clients because there are few better books for those with a sincere interest in learning the principles of successful investing. For many years, Train has studied the "investment greats" of our time. You will know some of these great investors, and some have been previously cited in *The View from Burgundy*, including Warren Buffett, John Templeton and Larry Tisch. *The Money Masters* studies nine of these great investors in some detail, exploring in particular their investment beliefs and philosophies, and the methods they use in making investment decisions.

In the book's final chapter, Train draws a number of conclusions from his study of these "Masters." One of the most useful conclusions is a list of "don'ts," which we are reprinting here for our readers because we feel the list is very relevant in today's investment world – that is, a world of high valuations for many stocks, some industries brimming with popularity and resultant high prices, and new equity issues abounding.

We think that you might be able to think up specific examples of situations that match up with the various points that Train is making!

Investment "Don'ts"

1. Avoid Popular Stocks:

> First must come the general class of anything that's too popular at the time, stocks that are on everybody's list. If you buy Polaroid when everybody feels it's cheap, you can be fairly sure that the stock is overvalued. It's not that the business won't do well or even that the stock will never rise; it's just that you will first have to work off that overvaluation, which takes time. IBM, then selling for 300, was a "religion stock" in the late 1960s, a certified member of the so-called Vestal Virgins. The company fulfilled all its owners' dreams: earnings went up 700% over the next decade, and

the dividend rose 1,000%. Still, for 10 years the stock never rose above 300. I often save the lists of "consensus" stocks published in magazines and check the results a year or two later. One may safely expect that they'll do about 30% worse than the averages. That's the sinister meaning of the term "glamour stock." A glamour stock is a good company overpriced because it's everybody's darling at the time. It's hard to make money buying one.

The same principle works for bursts of short-range enthusiasm. If a stock has run up widely over a period of days or weeks, it's better to let it rest for a while.

A highly favourable purchase is very likely to seem odd, uncomfortable, risky, dull or obscure at the time you buy it. Propitious reactions are: "That dog?" or "I can't see it doing anything for the next six months." Later, everybody gets the idea and feels comfortable or enthusiastic about it. Then it's too late.

2. Avoid Fad Industries:

Fads and brokers' stories are variations on popular stocks. The number of them you can remember is limited only by how old you are: the atomic energy craze of the fifties, the computer mania of the sixties, the gambling stock intoxication of 1978-79. There's an easy way to spot the terminal phase of these bubbles: if mutual funds are formed to concentrate on the industry in question, or if companies' stocks jump in the market because they announce that they propose to enter the field, then the buying is speculative and disappointment will probably follow. IBM and Xerox each made most of the money that was ever made in their respective industries. One would have been safer selling the stock of any other company that announced it was going into computers or copiers.

As I've mentioned, a good rule is that when a company changes its name to indicate that it's going into a new industry, it's time to have a skeptical look at that industry.

The easiest way to be sure that you are not buying into a fad or popular stock is to consult the index of the *Wall Street Transcript* or ask your broker to check his research file; if nothing's been written about a company for a few years, you're probably safe. If I'm interested in a company, I usually contact its shareholder relations officer and ask him what the best brokerage write-up is on his company. If there isn't any that really gets the point, then the discovery (or rediscovery) period is ahead of you.

A few years ago, for instance, H&R Block, the tax preparation company, seemed like a gift. They had a prodigious growth rate and no significant competition. The industry is imperishable, and the company was selling in the market for barely more than its cash in the bank. I asked Richard Bloch (that's how the family name is spelt), who didn't enjoy this state of affairs and was glad to be helpful, if there were any good current brokerage-house studies around. He said that there was only one he knew of, by an obscure individual practitioner. I considered that very bullish, and in fact the stock eventually did extremely well.

Perhaps the archetype of this principle was the first great American oil strike, the fabulous Spindletop Dome. It attracted so many investors that at its height one was said to be able to walk across the field stepping from one drilling platform to the next. Result: more money went into the ground at Spindletop than ever came out of the ground.

3. Avoid New Ventures:

Venture capital is for pros, not passive portfolio investors. By far the majority of new ventures – probably nine out of ten – go bust. Warren Buffett's argument is overwhelmingly convincing: There's little point in buying a gamble, of uncertain prospects and management, with the likelihood of financial asphyxiation in the future, and with the promoters getting a big free cut. If you wait a few years for the next bear market, you know you'll be able to buy the greatest companies in the world with superb managements already in place, for no more than their net quick assets, and with the company itself free – the plants, the patents, the goodwill.

4. Avoid "Official" Growth Stocks:

Stocks that have the growth label – and corresponding price tag – often are no longer growing rapidly enough to justify their prices. You might call them the "old champs." Many famous companies that have "Growth Stock" printed on the back of their robes and still wear the championship belt and buckle they won in 1958 are really over the hill.

5. Avoid Heavy Blue Chips:

A similar disappointment is likely to come from buying cyclical heavy-industry "blue chips" with static earnings, which sell for too high a price because of their "security." When you buy U.S. Steel and its famous peers you buy a cross-section of the modern world – whose problems for the investor exceed its opportunities. After realistic depreciation, the profits of these companies are usually substantially lower than reported, and even if there is a profit in accounting terms, there may be a cash deficit, covered by increasing the debt.

When you buy either the old champs or the heavy blue chips, the key is price: Is the rate of return really there? Will the reasonable flow of dividends give you what you need without any particular "leap of faith" and without any speculative assumptions about what the stock will sell for 10 years down the road at the end of the rainbow?

6. Avoid Gimmicks:

Gimmicky investment "products" with high transaction costs and no intrinsic growth of value, such as option programs and commodity flyers, aren't investments at all. They're casinos. Forget about them. The economic function of real investment is to provide the capital needed for industry, for a fair return. The economic function of the casino customer is to be fleeced.

7. Bonds Don't Preserve Capital:

A final bad deal for the investor, generally, is bonds, unless he reinvests all the income. The notion that they're "conservative" is grotesquely unrealistic. Franz Pick, in his sardonic way, has called them "certificates of guaranteed expropriation." After tax, bonds generally yield less than the inflation rate. The present half-life of money is eight to ten years; so, if you spend the income only half your buying power will remain after eight to ten years in real terms, and only one quarter after 16 to 20 years. You'll have to run through your capital without even realizing it. Incidentally, the Dow stocks plus their dividends have vastly outperformed savings accounts, with dividends compounded, over every 20-year period since 1928, and have more than kept up with inflation.

8. Forget About Technical Analysis:

One "system" of stock market investing not represented in this book is so-called technical analysis. The reason is that I have been unable to find any successful practitioners.[2]

Author: **Tony Arrell, Chairman and Chief Executive Officer**

July 1993

John Maynard Keynes on "Investing"

In the world of investing, the future is always uncertain. Nearly all successful practitioners of investing that we know of possess a strong philosophy that guides their investment approaches and actions.

Clients of Burgundy will be familiar with our philosophy of investing: to diligently search out companies of quality that are selling for significantly less than their "intrinsic value." We have various tools such as databases, computers and management interviews to help us do this. We read widely and talk to many executives and analysts. But the key to successful implementation, in our view, really lies in judgment and in temperament, having the confidence and courage to do what is usually quite unpopular. This is because investing in shares of companies that are significantly undervalued usually means investing in stocks that the public is currently avoiding. Often, some of the very best opportunities occur when the economic outlook is bleak and when each day in the newspaper there is a long list of stocks hitting new lows. We find that an investment philosophy, like all other philosophies of life, benefits from an occasional reinforcement. Such reinforcement or "tune-up," in our case, can come from a review of some of the great literature on investing and successful investors.

John Maynard Keynes was one of the greatest economists and thinkers on investments. He was at various times Bursar of King's College, Cambridge; Chairman of the National Mutual Life Insurance; as well as Director of Provincial Insurance and several investment trusts.

One of our favourite passages from Keynes's writing is "The State of Long-Term Expectation" from *The General Theory of Employment, Interest, and Money*. In this article, Keynes differentiates between long-term investing and second-guessing the crowd. It illustrates a principle that in our view is key to enduring success in investing. We repeat this section here for your interest.

A conventional valuation which is established as the outcome of the mass psychology of a large number of ignorant individuals is liable to change violently as the result of a sudden fluctuation of opinion due to factors which do not really make much difference to the prospective yield, since there will be no strong roots of conviction to hold it steady. In abnormal times in particular, when the hypothesis of an indefinite continuance of the existing state of affairs is less plausible than usual even though there are no express grounds to anticipate a definite change, the market will be subject to waves of optimistic and pessimistic sentiment, which are unreasoning and yet in a sense legitimate where no solid basis exists for a reasonable calculation.

But there is one feature in particular which deserves our attention. It might have been supposed that competition between expert professionals, possessing judgment and knowledge beyond that of the average private investor, would correct the vagaries of the ignorant individual left to himself. It happens, however, that the energies and skill of the professional investor and speculator are mainly occupied otherwise. For most of these persons are, in fact, largely concerned, not with making superior long-term forecasts of the probable yield of an investment over its whole life, but with foreseeing changes in the conventional basis of valuation a short time ahead of the general public. They are concerned, not with what an investment is really worth to a man who buys it 'for keeps', but with what the market will value it at, under the influence of mass psychology, three months or a year hence. Moreover, this behaviour is not the outcome of a wrong-headed propensity. It is an inevitable result of an investment market organized along the lines described. For it is not sensible to pay 25 for an investment of which you believe the prospective yield to justify a value of 30, if you also believe that the market will value it at 20 three months hence.

Thus the professional investor is forced to concern himself with the anticipation of impending changes, in the news or in the atmosphere, of the kind by which experience shows that the mass psychology of the market is most influenced. This is the inevitable result of investment markets organised with a view to so-called 'liquidity'. Of the maxims of orthodox finance none, surely, is more anti-social than the fetish of liquidity, the doctrine that it is a positive virtue on the part of investment institutions to concentrate their resources upon the holding of 'liquid' securities. It forgets that there is no such thing as liquidity of investment for the community as a whole. The social object of skilled investment should be to defeat the dark forces of time and ignorance which envelop our future. The actual, private object of the most skilled investment today is 'to beat the gun', as the Americans so well express it, to outwit the crowd, and to pass the bad, or depreciating, half-crown to the other fellow.

This battle of wits to anticipate the basis of conventional valuation a few months hence, rather than the prospective yield of an investment over a long term of years, does not even require gulls amongst the public to feed the maws of the professional; it can be played by professionals amongst themselves. Nor is it necessary that anyone should keep his simple faith in the conventional basis of valuation having any genuine long-term validity. For it is, so to speak, a game of snap, of Old Maid, of Musical Chairs – a pastime in which he is victor who says Snap neither too soon nor too late, who passes the Old Maid to his neighbour before the game is over, who secures a chair for himself when the music stops. These games can be played with zest and enjoyment, though all the players know that it is the Old Maid which is circulating, or that when the music stops some of the players will find themselves unseated.

Or, to change the metaphor slightly, professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view. It is not a case of choosing those which, to the best of one's judgment, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practise the fourth, fifth and higher degrees.

If the reader interjects that there must surely be large profits to be gained from the other players in the long run by a skilled individual who, unperturbed by the prevailing pastime, continues to purchase investments on the best genuine long-term expectations he can frame, he must be answered, first of all that there are, indeed, such serious-minded individuals and that it makes a vast difference to an investment market whether or not they predominate in their influence over the game players. But we must also add that there are several factors which jeopardise the predominance of such individuals in modern investment markets. Investment based on genuine long-term expectation is so difficult today as to be scarcely practicable. He who attempts it must surely lead much more laborious days and run greater risks than he who tries to guess better than the crowd how the crowd will behave; and, given equal intelligence, he may make more disastrous mistakes. There is no clear evidence from experience that the investment policy which is socially advantageous coincides with that which is most profitable. It needs more intelligence to defeat the forces of time and our ignorance of the future than to beat the gun. Moreover, life is not long enough; human nature desires quick results, there is peculiar zest in making money quickly, and remoter gains are discounted by the average man at a very high rate. The game of professional investment is intolerably boring and overexacting to anyone who is entirely exempt from the gambling instinct; whilst he who has it must pay to this propensity the appropriate toll. Furthermore, an investor who proposes to ignore near-term market fluctuations needs greater resources for safety and must not operate on so large a scale, if at all, with borrowed money – a further reason for the higher return from the pastime to a given stock of intelligence and resources. Finally it is the long-term investor, he who most promotes the public interest, who will in practice come in for most criticism, wherever investment funds are managed by committees or boards or banks. For it is in the essence of his behaviour that he should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful, that will only confirm the general belief in his rashness; and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy. Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.

So far we have had chiefly in mind the state of confidence of the speculator or speculative investor himself and may have seemed to be tacitly assuming that, if he himself is satisfied with the prospects, he has unlimited command over money at the market rate of interest. This is, of course, not the case. Thus we must also take account of the other facet of the state of confidence, namely, the confidence of the lending institutions towards those who seek to borrow from them, sometimes described as the state of credit. A collapse in the price of equities, which has had disastrous reactions on the marginal efficiency of capital, may have been due to the weakening either of speculative confidence or of the state of credit. But whereas the weakening of either is enough to cause a collapse, recovery requires the revival of both. For whilst the weakening of credit is sufficient to bring about a collapse, its strengthening, though a necessary condition of recovery, is not a sufficient condition.[3]

Author: **Tony Arrell, Chairman and Chief Executive Officer**

October 1993

Investing at Burgundy

The world of investing can be a very lonely place at times. We have learned over the years, however, that successful investors have developed their own philosophy that guides their investment approach and their actions through that sea of market sentiment. At times, the most important decision is not the individual buy or sell order, but the decision to stick with the investment philosophy you feel is right.

Clients of Burgundy will be familiar with our philosophy of investing: to diligently search out companies of quality that are selling for significantly less than their intrinsic value. Conversely, we sell securities that have become overpriced. While our philosophy is simplistic, it is far from simple to implement. We regularly calculate the intrinsic value of hundreds of companies, and compare those values to what the market is willing to pay for them. Out of all of those calculations, there will be a few companies that will appear to be undervalued. Then the real work starts. Each of the companies that appears to be undervalued will be examined extensively for financial soundness, investor-oriented management and clarity of financial reporting. We regularly interview the management of companies we are interested in and maintain those contacts once we have bought shares of that company. When we do decide to buy a company, we do so because we are confident in our own evaluation, not because we hope that market sentiment will move the share price higher.

At Burgundy, we have invested in the tools we need to perform these numerous evaluations independently, such as databases, computer hardware and other source documents. We read widely and talk to many executives and analysts to understand the business environment of specific companies. But the real key to the successful implementation of an investment philosophy, we think, lies in having good judgment, patience and the right temperament.

The most difficult aspect of investing is to have the confidence and courage to do what is usually quite unpopular. This is because investing in shares of companies that are significantly undervalued often means investing in stocks that the investing public is currently avoiding. Often, some of the best opportunities occur when the economic outlook is bleak and when each day in the newspaper there is a long list of stocks hitting new lows. Suffice to say, today's environment is quite the opposite; the new-lows list has seldom been shorter.

But no investment philosophy, like other philosophies of life, is static. Occasionally, you must revisit your beliefs to reinforce currently held assumptions and glean new perspectives. Such a reinforcement, in our case, can come from a review of some of the great literature on investing and a careful study of successful value investors such as Warren Buffett.

Warren Buffett is one of the great businessmen of our day and a great thinker on investments. He is the Chairman of Berkshire Hathaway and an eminent investor. Forbes (October 1993) declared that he is the richest man in America, with $8 billion of net worth. So strong is our confidence in his ability to invest that several Burgundy Funds are shareholders of Berkshire Hathaway.

We are particularly fond of an essay Buffett prepared for a class at Columbia University in 1984 commemorating the 50th anniversary of *Security Analysis*, the famous book written by Benjamin Graham and David L. Dodd. The talk dealt with the merits of value investing and the success of some of Ben Graham's students. It also pokes fun at some of the institutional investing maxims of our day, such as volatility. Here were some of his comments:

> In this group of successful investors that I want to consider, there has been a common intellectual patriarch, Ben Graham…. The common intellectual theme of the investors from Graham-and-Doddsville is this: they search for discrepancies between the value of a business and the price of small pieces of that business in the market. Essentially, they exploit those discrepancies without the efficient market theorist's concern as to whether the stocks are bought on Monday or Thursday, or whether it is January or July, etc. Incidentally, when businessmen buy businesses – which is just what our Graham & Dodd investors are doing through the medium of marketable stocks, I doubt that many are cranking into their purchase decision the day of the week or the month in which the transaction is going to occur. If it doesn't make any difference whether all of a business is being bought on a Monday or a Friday, I am baffled why academicians invest extensive time and effort to see whether it makes a difference when buying small pieces of those same businesses. Our Graham & Dodd investors,

needless to say, do not discuss beta, the capital asset pricing model, or covariance in returns among securities. These are not subjects of any interest to them. In fact, most of them would have difficulty defining those terms. The investors simply focus on two variables: price and value.

I always find it extraordinary that so many studies are made of price and volume behaviour, the stuff of chartists. Can you imagine buying an entire business simply because the price of the business had been marked up substantially last week and the week before? Of course, the reason a lot of studies are made of these price and volume variables is that now, in the age of computers, there are almost endless data available about them. It isn't necessarily because such studies have any utility; it's simply that the data are there and academicians have worked hard to learn the mathematical skills needed to manipulate them. Once these skills are acquired, it seems sinful not to use them, even if the usage has no utility or negative utility. As a friend said, to a man with a hammer, everything looks like a nail.

I think the group that we have identified by a common intellectual home is worthy of study. Incidentally, despite all the academic studies of the influence of such variables as price, volume, seasonality, capitalization, size, etc. upon stock performance, no interest has been evidenced in studying the methods of this unusual concentration of value-oriented winners.

While they differ greatly in style, these investors are, mentally, always buying the business, not buying the stock. A few of them sometimes buy whole businesses. Far more often they simply buy small pieces of businesses. Their attitude, whether buying all or a tiny piece of a business, is the same. Some of them hold portfolios with dozens of stocks; others concentrate on a handful. But all exploit the difference between the market price of a business and its intrinsic value.

I'm convinced that there is much inefficiency in the market. These Graham-and-Doddsville investors have successfully exploited gaps between price and value. When the price of a stock can be influenced by a "herd" on Wall Street with prices set at the margin by the most emotional person, or the greediest person, or the most depressed person, it is hard to argue that the market always prices rationally. In fact, market prices are frequently nonsensical.

I would like to say one important thing about risk and reward. Sometimes risk and reward are correlated in a positive fashion. If someone were to say to me, "I have here a six-shooter and I have slipped one cartridge into it. Why don't you just spin it and pull it once? If you survive, I will give you $1 million." I would decline – perhaps stating that $1 million is not enough. Then he might offer me $5 million to pull the trigger twice – now that would be a positive correlation between risk and reward.

The exact opposite is true with value investing. If you buy a dollar bill for 60 cents, it's riskier than if you buy a dollar bill for 40 cents, but the expectation of reward is greater in the latter case. The greater the potential for reward in the value portfolio, the less risk there is.

One quick example: The Washington Post Company in 1973 was selling for $80 million in the market. At the time, that day, you could have sold the assets to any one of ten buyers for not less than $400 million, probably appreciably more. The company owned the Post, Newsweek, plus several television stations in major markets. Those same properties are worth $2 billion now, so the person who would have paid $400 million would not have been crazy.

Now, if the stock had declined even further to a price that made the valuation $40 million instead of $80 million, its beta would have been greater. And to people who think beta measures risk, the cheaper price would have made it look riskier. This is truly Alice in Wonderland. I have never been able to figure out why it's riskier to buy $400 million worth of properties for $40 million than $80 million. And, as a matter of fact, if you buy a group of such securities and you know anything at all about business valuation, there is essentially no risk in buying $400 million for $80 million, particularly if you do it by buying ten $40 million piles for $8 million each. Since you don't have your hands on the $400 million, you want to be sure you are in with honest and reasonably competent people, but that's not a difficult job.

You also have to have the knowledge to enable you to make a very general estimate about the value of the underlying businesses. But you do not cut it close. That is what Ben Graham meant by having a margin of safety. You don't try and buy businesses worth $83 million for $80 million. You leave yourself an enormous margin. When you build a bridge, you insist it can carry 30,000 pounds, but you only drive 10,000-pound trucks across it. And that same principle works in investing.

In conclusion, some of the more commercially minded among you may wonder why I am writing this article. Adding many converts to the value approach will perforce narrow the spreads between price and value. I can only tell you that the secret has been out for 50 years, ever since Ben Graham and Dave Dodd wrote *Security Analysis*, yet I have seen the trend toward value investing in the 35 years that I've practiced it. There seems to be some perverse human characteristic that likes to make easy things difficult. The academic world, if anything, has actually backed away from the teaching of value investing over the last 30 years. It's likely to continue that way – ships will sail around the world but the Flat Earth Society will flourish. There will continue to be wide discrepancies between price and value in the marketplace, and those who read their Graham & Dodd will continue to prosper.[4]

Author: **Tony Arrell, Chairman and Chief Executive Officer**

January 1994

The Market Valuations

Every once in a blue moon, securities markets go to extremes and currently we appear to have such a situation. Small investors are flocking to stocks, taxi drivers are talking about stocks, Initial Public Offerings are coming to market hourly; and exotic funds and emerging markets are all the rage. Equity mutual funds in Canada increased their assets by 65% in the past year. The "new highs list" in the newspaper outnumbers the "new lows list" by a ratio of 10 to 1 on many days.

In this article, we will review the historical valuation statistics of equity markets in both Canada and the U.S. Our conclusion is that stock markets are at abnormally high levels by traditional measures. This does not necessarily mean stock markets are at a risk of imminent decline; prior markets have defied gravity, sometimes for several years (e.g., Japan in the late 1980s). And as a close friend used to say in university, "If you leave the party too early, you'll miss a lot of the fun!"

Clients, friends and regular readers will know that Burgundy's investment philosophy is to focus on value by seeking out individual securities that are selling for less than they are worth. Our primary orientation is towards equities and we are long-term oriented, and this is where we direct most of our research effort: putting companies under an analytical microscope, tearing apart their financial statements and assessing their management. We spend relatively little time trying to forecast interest rates, the economy or the securities market as a whole. In our mind, these macro factors are basically not predictable and trying to predict them is kind of like weather forecasting. We share the view of Peter Lynch who said in a speech given in Toronto last fall, "If you spent 15 minutes in 1993 worrying about the economy, you spent 12 minutes too much." [5]

But the current market activity and valuation is so unusual that we have recently spent a fair amount of time researching and pulling together key statistics on the valuation of the market as a whole, both as a background for our readers' consideration and also to help guide our own investment judgments.

Our work begins with an estimate of the "intrinsic value" of the overall market. In a nutshell, what a stock (or, in this instance, an index) is worth depends on what it can earn. To arrive at this value, we begin with the shareholders' equity, or book value of the index. Then we look at the kinds of returns that have been generated over an extended period on that book value (i.e., return on equity). This will give us a general idea of what would be a "normal" earnings level for the index (serious judgment now enters the process, for the future won't necessarily reflect the past). The final exercise is to put an appropriate multiplier on these normalized earnings – for this we use the reciprocal of prevailing long-term interest rates. Conclusion: the TSE Index, at today's 4400 level, is well above its intrinsic worth of approximately 3200-3400. Our estimate of the U.S. market shows that its degree of overvaluation is even more pronounced (estimated value is in the range of 2600-2800).

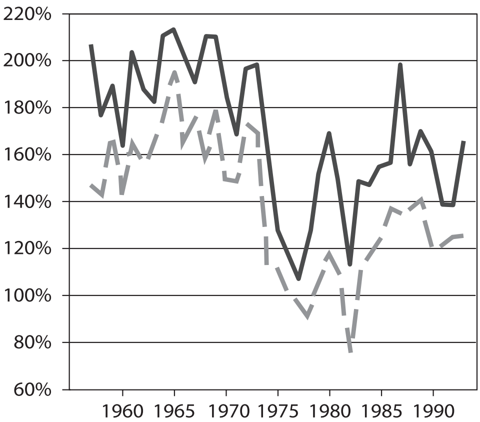
Whenever the market has reached this degree of overvaluation in the past, investors received disappointing returns in the ensuing years. The average annual return from the TSE stocks over the long term is about 10% per year; but obviously, those who buy near market highs will experience much lower long-term returns, and astute investors who buy during market dips will get better than a 10% compound rate of return.

What is abundantly clear from a review of stock prices is that they fluctuate significantly during their upward march. And it is during these periods of extreme prices that opportunity knocks particularly loudly. Taking advantage of buying opportunities requires discipline and conviction, for at those times such action is difficult, with popular sentiment running heavily against stocks and all-around negative economic news. Conversely, in the euphoria of a bull market, one requires exactly the same discipline in reverse.

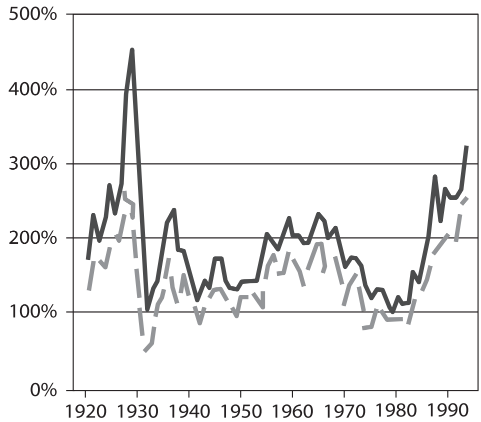
Today, what is required is the courage to sell when the majority of investors are clamoring for stock and when economic news is positive. A wise man once said, "It isn't how much you make, but how much you keep!" Raising cash is not necessarily a wimpy act; we feel that it will provide buying power when true bargains are plentiful once again.

Let us look at how those prices compare to the underlying assets or "book value" of the major Canadian and U.S. stock markets.

TSE 300 COMPOSITE
Price to Book Value 1957-1993



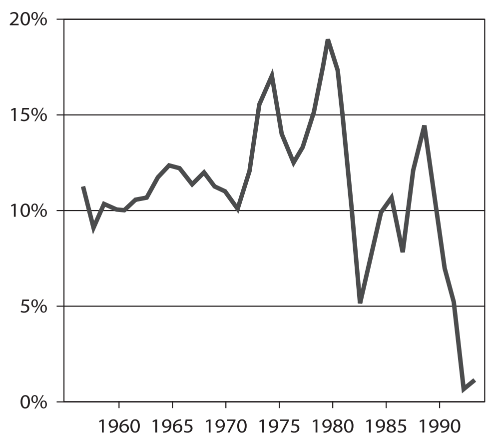
DOW JONES INDUSTRIALS
Price to Book Value 1921-1993



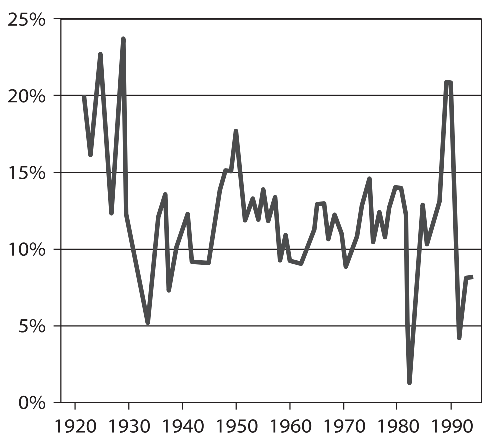
Source: Burgundy Investment Team Research

The Toronto market today appears abnormally high in relation to its recent history, although in the 1960s and 1970s stocks traded in this range of book value ratios. During the 1960s and 1970s, however, Canadian-listed companies were far more profitable than today; they provided better after-tax returns than bonds and so they were in great demand. With bonds yielding 5-6% throughout the 1960s, returns on equity of 10-15% looked pretty attractive. Thus, the price-to-book ratios tended toward hefty premiums. A picture of just how badly profitability (ROE) of the TSE companies has declined is evidenced in the chart above. This pattern of declining profitability is not evident in the Dow Jones Industrial Index.

TSE 300 COMPOSITE
Return on Common Equity



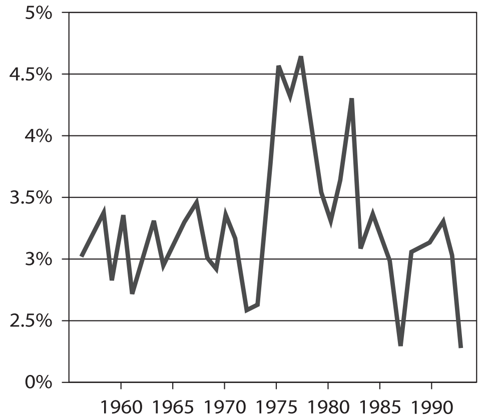
DOW JONES INDUSTRIALS
Return on Equity 1921-1993



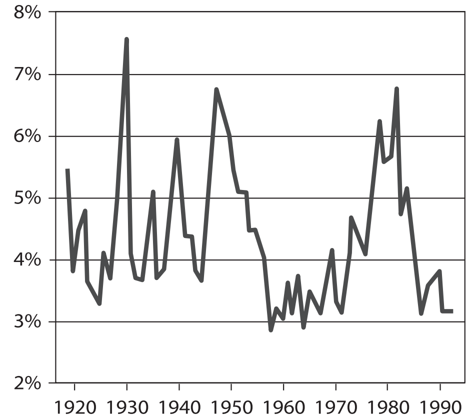
Source: Burgundy Investment Team Research

Now let's take a look at dividend yields through the years.

TSE 300 COMPOSITE
Dividend Yield 1956-1993



DOW JONES INDUSTRIALS
Dividend Yield 1921-1993

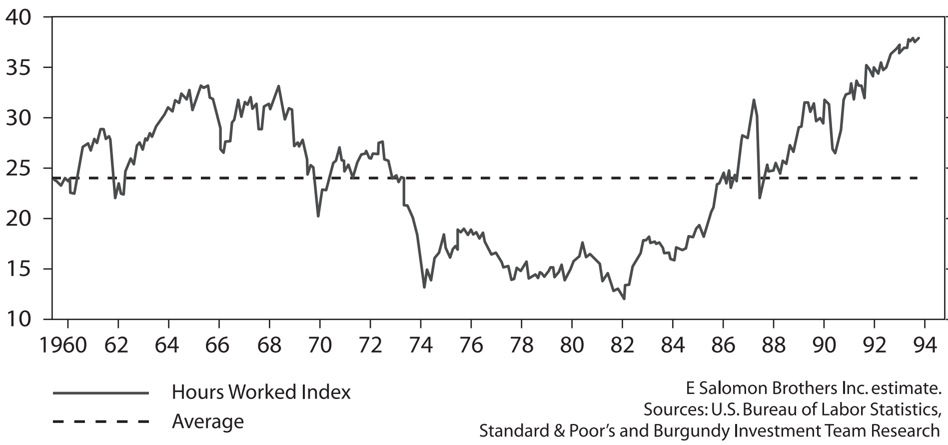


Source: Burgundy Investment Team Research

It isn't very encouraging. Today the TSE Composite Index yields around 2.2%, which is the lowest on the record. (The Dow is at 2.6% – also at a record low.) While other comparative statistics suffer various criticisms due to changing accounting practices, write-offs, and so on, the cash dividend yield is factual and has proven to be a reliable indicator in the past. Today's low yields are discomforting.

One final interesting way to look at the valuation of the market is provided in the chart below, which shows the number of hours of work at the average wage rate needed to buy one S&P unit. At 38 hours, it is the highest on record.

HOURS OF WORK NEEDED TO BUY ONE S&P UNIT 1960-93E



E Salomon Brothers Inc. estimate.
Sources: U.S. Bureau of Labor Statistics,
Standard & Poor's and Burgundy Investment Team Research

We have no idea what the market is going to do. We feel that we can say with certainty that North American equity markets have almost never sold so high relative to earnings, dividends, book value or labour earnings. Possibly the economy could have such a great boom that the current pricing will eventually be justified. Or, maybe money flows from back deposits and CDs will just keep driving stock prices up, notwithstanding the valuation levels of stocks.

What we can say is the current level of pricing is causing us to go about our business of managing your money in a very cautious way. At Burgundy, at the moment, we have more than a normal amount of cash; we have long bonds, and the bonds we hold are of a short duration (some of which are inflation-indexed). We are especially fussy about our equity positions – and we only own stocks in companies that we have confidence in and that are below their intrinsic value. Where appropriate, we have partly insured against a market decline using S&P Index "put options."

We feel that our portfolios are positioned to benefit from rising stock prices, yet we have sound downside protection. We should hasten to add that our caution has not led to weak investment results. We are pleased to learn that our Canadian Equity Fund – which increased in value by 57% for the 12 months ended November 30, 1993 – placed Burgundy at the top of the 49 pooled Canadian equity funds measured by the latest Towers Perrin Survey.

The performance of our Funds in a rising market is fine, so far. Yet we are mindful of our primary duty – to protect our clients' capital. We take that responsibility seriously and we are doing something about it. When our clients rest easy, so do we.

Author: **Tony Arrell, Chairman and Chief Executive Officer**

May 1994

Berkshire Hathaway's '94 AGM

Most people who are readers of *The View from Burgundy* are quite familiar with Warren Buffett. According to Forbes magazine, he is currently the richest man in America through his holdings of Berkshire Hathaway stock. His investment record with Berkshire Hathaway over the last 27 years is so superior to what any market index has done that it cannot be attributed to good fortune or chance. Clearly, Warren Buffett is the greatest investor of our time, and there is much that can be learned from his writings and his answers at the Berkshire Annual General Meeting (AGM).

In order to glean some further insights into the way that Buffett invests, and his views on current market issues, we journeyed to Omaha for the Berkshire AGM. In preparation for the meeting, we read Berkshire's Annual Report, and in particular, the Chairman's Letter. Once again, we were struck by the common sense logic both of Buffett's writings and his thoughts. That same common sense approach, which bears greater tribute to the intelligence of the author than the mathematical modelling approach to investing that dominates today's environment, was very much in evidence. This quarter's *View* is a reflection of the thoughts and ideas that were expressed at that meeting.

The business part of the meeting lasted seven minutes, followed by a 3.5-hour question and answer session handled by Warren Buffett and his associate, Charlie Munger, Vice-Chairman.

Staying Within Your Circle of Competence

- Buffett emphasized several times that an important factor in the success of Berkshire is staying within its circle of competence. He said, "Charlie and I don't like difficult problems." [6]
- He spoke of the danger of hiring experts. He said, "Don't ask the barber if you need a haircut." [7]

- He emphasized how little really goes on at the headquarters of Berkshire, and how old fashioned it is. He pointed out that at this moment, while the meeting is going on, there was only one secretary at Berkshire's head office. The company's Chief Financial Officer was manning the microphone at the company's AGM. Buffett spent his time at the office reading and on the phone. There are no formal meetings at Berkshire.
- Munger spoke of the "eternal verities" [8] in business.
- Buffett said that he has no views on the economy or the stock market. He is an "agnostic" on these issues. He feels they are of no value in making successful investments.

Risk

- One key aspect to risk is how long you expect to hold an investment (e.g., stock in Coca Cola might be very risky if bought for a day trade or held for only a week). But, over a 5- or 10-year period it probably has almost no risk at all.
- The myth that volatility of a stock somehow equates to risk was discussed. In Buffett's view, volatility in fact often created great opportunity. The following comments on risk in investments were on page 14 of the 1993 Annual Report:

Charlie and I decided long ago that in an investment lifetime it's just too hard to make hundreds of smart decisions. That judgment became ever more compelling as Berkshire's capital mushroomed and the universe of investments that could significantly affect our results shrank dramatically. Therefore, we adopted a strategy that required our being smart – and not too smart at that – only a very few times. Indeed, we'll now settle for one good idea a year. (Charlie says it's my turn.)

The strategy we've adopted precludes our following standard diversification dogma. Many pundits would therefore say the strategy must be riskier than that employed by more conventional investors. We disagree. We believe that a policy of portfolio concentration may well decrease risk if it raises, as it should, both the intensity with which an investor thinks about a business and the comfort level he must feel with its economic characteristics before buying into it. In stating this opinion, we define risk, using dictionary terms, as "the possibility of loss or injury."

Academics, however, like to define investment "risk" differently, averring that it is the relative volatility of a stock or portfolio of stocks – that is, their volatility as compared to that of a large universe of stocks. Employing databases and statistical skills, these academics compute with precision the "beta" of a stock – its relative volatility in the past – and then build arcane investment and capital-allocation theories around this calculation. In their hunger for a single statistic to measure risk, however, they forget a fundamental principle: It is better to be approximately right than precisely wrong.

For owners of a business – and that's the way we think of shareholders – the academics' definition of risk is far off the mark, so much so that it produces absurdities. For example, under beta-based theory, a stock that has dropped very sharply compared to the market – as had Washington Post when we bought it in 1973 – becomes "riskier" at the lower price than it was at the higher price. Would that description have then made any sense to someone who was offered the entire company at a vastly reduced price? [9]

- Charlie Munger stated, "A lot of modern finance theory can only be described as disgusting." [10]

Derivatives

- Buffett believed that derivatives were a potential major risk for financial markets. He referred to the Carole Loomis article in Fortune magazine a month ago as an excellent discussion on the subject.
- He said that the "combination of ignorance and borrowed money" [11] usually leads to serious problems. This is the second year Buffett has warned of possible dangers from derivatives.

Management

- Buffett thought that there were two main factors in assessing management:
  - How have their results been?
  - How do they treat the company's shareholders? Look also at how management treat themselves relative to the shareholder by reading the proxy circular.
- Buffett said that he advocates "finding the 0.400 batters, and letting them swing." [12] Buffett later went on to say that one of the two or

three most important things a Chief Executive Officer does is to allocate capital (i.e., invest money – either retained earnings or new outside capital). Yet few CEOs are trained for capital allocation because they rose through other streams in the business such as operations, sales or finance. Referring still to capital allocation, Buffett said that most CEOs, when they get the top job, are "like a concert pianist arriving at Carnegie Hall – only to be handed a violin." [13] Often, CEOs who are inexperienced in the field of capital allocation will rely on so-called "experts"; Buffett saw this as extremely dangerous.

Various Investments

Private Investments vs. Public Investments

- Berkshire has previously said that it would prefer more private investments but has had trouble finding suitable ones. At the present time, the public market offers more opportunity. There are very few good private situations around and those that are available tend to be overpriced. Berkshire has a billion dollars in cash at present.
- Buffett said that there is more possibility of significant "mispricing" in the public stock market. This is because emotion plays a larger role both in the public market and in the very superficial knowledge with which most investors operate. On the other hand, owners of significant private businesses tend to have a much better idea of what their businesses are really worth.
- There is very tough competition currently for the few good private businesses of decent size from:
  - MBO funds or LBO funds: Typically these funds are run by people using other people's capital; they benefit from upside but don't suffer as much from downside since it is not their money that is at stake. Therefore, they are less worried about overpaying for a business.
  - Other public companies: They don't mind overpaying; management of these types of companies are often more focused on size than on return on investment, and often they are not big shareholders. These types of buyers don't mind issuing new stock in payment, whereas Berkshire doesn't like to issue new common stock.
- Buffett definitely felt that the "stock market is far less efficient than the private market." [14]

Permanent Investments

- Buffett and Munger viewed the following Berkshire investments as "permanent holdings":
  - The Washington Post
  - Capital Cities/ABC
  - GEICO
  - Coca Cola

Banks

- Banks are much better capitalized today than several years ago. Loan demand is down; therefore, some of this surplus capital is not currently needed. Acquisitions and share repurchasing may continue to be a strong feature of the bank industry in the near future as a result of this excess capital.

Tobacco

- Buffett said that he wouldn't want too much of his net worth invested in this industry and that its future will ultimately depend upon the view of society as a whole.
- He said that last year, Berkshire Hathaway was rumoured in the press to be purchasing shares in at least 10 different companies. He said that in the "majority of cases," the rumours were wrong. U.S. Tobacco, Philip Morris and Wrigley were among those that Berkshire was allegedly buying. We suspect that Wrigley meets Buffett's investment criteria except maybe as to the current share price.

General Electric

- Buffett spoke very highly of the Company and its chairman, Jack Welch.

Freddie Mac/Fannie Mae

- They can create insurance products significantly cheaper than savings and loan companies.

Insurance

"Supercat" Insurance Risks

- There are two big risk possibilities in Berkshire's "supercatastrophe" business:
  - a hurricane – especially if it occurred over Long Island or the Northeastern United States
  - and/or a major earthquake.

- He spoke very highly of Berkshire Hathaway's management, and reiterated that Berkshire's huge net worth gives the company an enormous competitive advantage in this area over all of its competitors.
- GEICO could withstand a few catastrophes in a row.
- New Bermuda insurance companies have brought $2-3 billion in new capital and caused more competition in reinsurance rates.
- Berkshire tries to "price to exposure," whereas most large insurance companies "price to experience."
- Buffett emphasized not letting the market think for you.

Reinsurance

- Buffett thought that a lot of dumb things are done in the reinsurance business. This is an industry where "you don't know who is swimming naked until the tide goes out." [15]

Various Musings

Appropriate Discount Rates

- Buffett stated that the proper way to value an investment is by discounting the future estimated stream of free cash flow. Buffett said that he would use a discount rate of around 10% if the government long-term bond yield was 7%.

The Federal Reserve Board

- There was a question on the effectiveness of the Federal Reserve. Greenspan has a very tough job and Buffett seemed to feel that he does it reasonably well.
- The Fed's main job is "to take away the punch bowl once in a while," [16] he said.

Regarding Synergy

- Both Coke and Gillette are doing business in China. A negative for Gillette is that the Chinese shave less often than we do in the West. Buffett wondered if "something could be put in the Coke" [17] to get the Chinese to shave more frequently!

Taxes

- Buffett said that he would prefer a steeply progressive consumption tax and would emphasize this rather than income tax. But, he felt that the rich get a good deal in America.

Favourite New Books

- Someone asked about Buffett's favourite new books:
  - Janet Lowe's biography of Ben Graham is being released in September 1994 (Buffett has read the galleys and thinks it is good).
  - Connie Bruck's biography of Steve Ross (the deceased former chairman of Time Warner).
  - Later, Buffett again mentioned *The Intelligent Investor* by Benjamin Graham as the most important investment book, especially Chapters 8 and 20.
  - Buffett, in earlier years, has also referred to the two books by Phil Fischer as key reading for serious investors.
  - He also recommended *The General Theory of Employment, Interest, and Money* by Keynes.

Hedging Currencies

- Berkshire doesn't hedge its currency exposure. Why spend money to hedge a 50/50 proposition (i.e., a random event)?

As we have previously stated, Burgundy's investment philosophy is based on buying securities of good companies when they are selling below "intrinsic value," with a significant margin of safety.

We think of stocks as fractions of companies (which they are!) and analyze them accordingly.

We know of no better spokesman of many of these principles than Warren Buffett and hope that our readers find his thoughts of value.

Author: **Tony Arrell, Chairman and Chief Executive Officer**

August 1994

Bonds – Value Investments?

Clients, readers of *The View from Burgundy* and friends of this firm will know that our approach to investing is to emphasize equities. We look for equities in quality companies that are selling for less than their intrinsic value, with a large margin of safety. Historically, equities have had twice the annual return of bonds over the past 50 years. We tend to give short shrift to overview forecasts, including interest rate forecasts. In our experience, such forecasts are highly unreliable. There is a lot in what Peter Lynch of Fidelity said in a speech given in Toronto a year ago: "If you spent 15 minutes worrying about economics last year, you spent 12 minutes too much." [5]

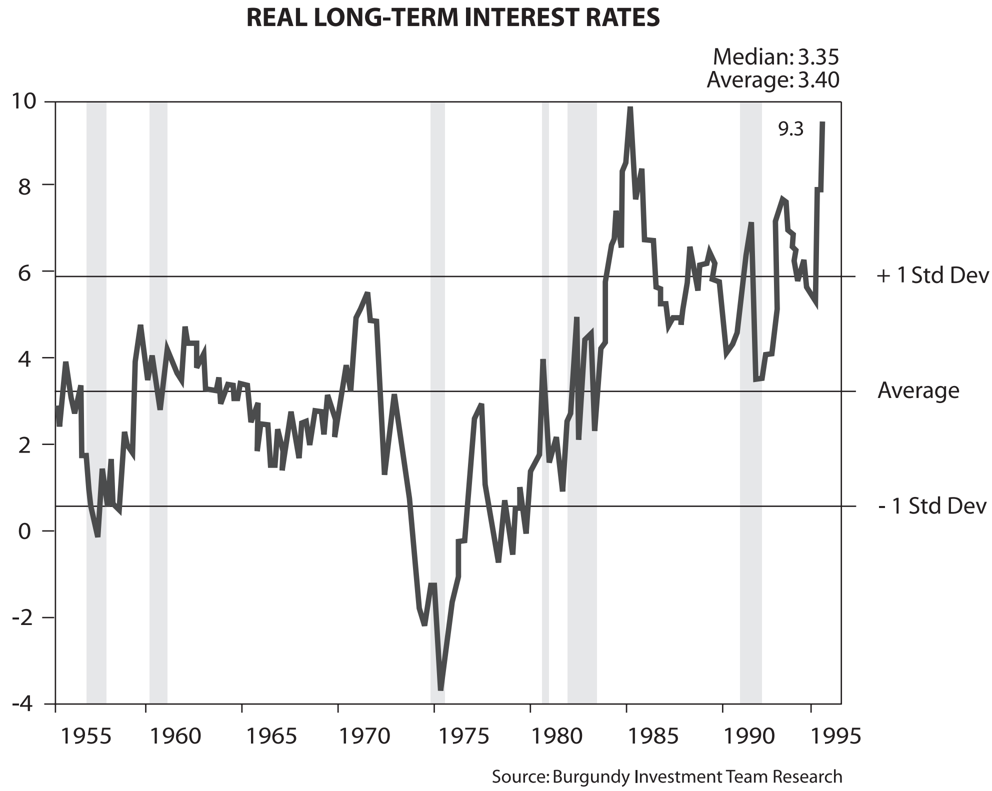
But what has happened to both bond prices and to bond yields in the past three to four months has been dramatic. It may become a big factor in how stocks are priced in the period ahead. We thought the subject very important and worthy of some analysis and comment.

Bond prices have sustained a tremendous decline so far in 1994. All countries have experienced this same phenomenon as interest rates have gone up, and bond prices of all types have fallen. Canadian bond prices have been hit especially hard: in part because of how weak our dollar has been, in part because of uncertainty in Quebec and of increasing concern about the financial solidarity of the country as a whole. The chart on the following page, which is courtesy of John Atkins of DFI Securities, shows that 10-year Canada government bond prices have now fallen by about 18% in the past six months, compared to a decline of 14% in Britain and 10% in the United States.

The result of falling bond prices is, of course, that interest rates go up proportionately.

"Real" interest rates are the nominal or apparent interest rate, less the prevailing rate of inflation. For Government of Canada bonds of 10 years, the "real rate of interest" has historically averaged 3.35% over the past 40 years. Right now, the real interest rate on these bonds is 9.0% in Canada – part of the reason is obviously that we have almost no inflation at the present time.

The next chart shows the picture clearly. Notice that real rates have gone up by 50% in the past six months, from 6% in December 1993 to 9% today.

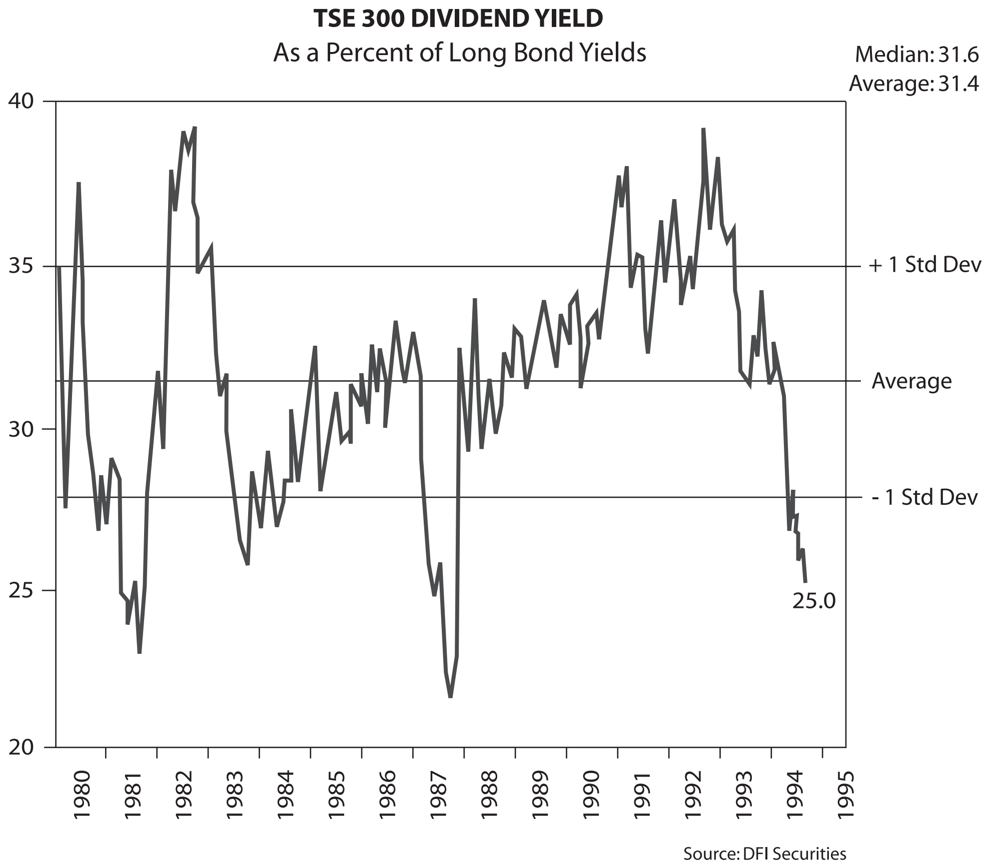


We would like to remind you of the long-term results of different classes of investments, which are kept track of by Ibbotson Associates, whose statistics go back to 1926. They show that, during the past 68 years, annual rates of return have been:

• Stocks (small):	12.4%
• Stocks (large):	10.3%
• Long-term Government Bonds:	5.0%
• Treasury Bills:	3.7%
• Inflation:	3.1% [18]

Stocks, long term, have earned 10-12% per annum, only a little more than what bonds are currently earning. As the previous chart also shows, real interest yields of 9% are a "two-standard deviation event." The only other time in the past 40 years that real interest rates were so far above the norm was in the early 1980s.

Another way to think about bond values versus stock values is to compare the dividend yields on stocks to the interest yield on bonds. The next chart (also from DFI) compares stock yields as a percentage of long-term bond yields for the past 15 years.



On average in Canada, stocks yield 31.4% as much as bonds. Today, stocks are yielding only 25.6% as much as bonds.

Without trying to predict the future, it is pretty obvious that with real returns of 9%, bonds will likely be a big competitor for money that might otherwise be bound for the stock market.

A Management Scorecard

There is no doubt that the capability of the senior management is perhaps the most important variable in the success of a business enterprise. As a result, management is ultimately critical in how the shares of a company perform over the long run.

Yet assessing management is extremely difficult for someone who isn't really on the inside of an enterprise. Unfortunately, this is the position of most investors or investment analysts. In our own case at Burgundy, we view any attempt to assess management of companies in which we invest to be one of the most important, yet most difficult, things that we do. It is certainly the least scientific part of the investment research process!

Despite its importance, little has been written about judging management from the point of view of the investor. Warren Buffett speaks to this subject occasionally and, as with most subjects he discusses, he has some highly useful things to say. Below is a collection of comments he has made in earlier Berkshire Hathaway annual reports:

- Our share issuances follow a simple basic rule: we will not issue shares unless we receive as much intrinsic business value as we give. Such a policy might seem axiomatic. Why, you might ask, would anyone issue dollar bills in exchange for fifty-cent pieces? Unfortunately, many corporate managers have been willing to do just that.
- The first choice of these managers in making acquisitions may be to use cash or debt. But frequently, the CEOs' cravings outpace cash and credit resources (certainly mine always have). Frequently, also, these cravings occur when his own stock is selling far below intrinsic business value. This state of affairs produces a moment of truth. At that point, as Yogi Berra has said, "You can observe a lot just by watching." For shareholders then will find which objective the management truly prefers – expansion of domain or maintenance of owner's wealth.
- But when the buyer makes a partial sale of itself – and that is what the issuance of shares to make an acquisition amounts to – it can customarily get no higher value set on its shares than the market chooses to grant it.
- Although our form is corporate, our attitude is partnership. Charlie Munger and I think of our shareholders as owner-partners, and of ourselves as managing partners. (Because of the size of our share holdings we also are, for better or worse, controlling partners.) We do not view the company itself as the ultimate owner of our business assets but, instead, view the company as a conduit through which our shareholders own the assets.
- We do not measure the economic significance or performance of Berkshire by its size; we measure by per-share progress.
- Accounting consequences do not influence our operating or capital-allocation decisions. When acquisition costs are similar, we much prefer to purchase $2 of earnings that is not reportable by us under standard accounting principles than to purchase $1 of earnings that is reportable. This is precisely the choice that often faces us since entire businesses (whose earnings will be fully reportable) frequently sell for double the pro-rata price of small portions (whose earnings will be largely unreportable).

In aggregate and over time, we expect the unreported earnings to be fully reflected in our intrinsic business value through capital gains.

- A managerial "wish list" will not be filled at shareholder expense. We will not diversify by purchasing entire businesses at control prices that ignore long-term economic consequences to our shareholders. We will only do with your money what we would do with our own, weighing fully the values you can obtain by diversifying your own portfolios through direct purchases in the stock market.
- We feel noble intentions should be checked periodically against results. We test the wisdom of retaining earnings by assessing whether retention, over time, delivers shareholders at least $1 of market value for each $1 retained. To date, this test has been met. We will continue to apply it on a five-year rolling basis. As our net worth grows, it is more difficult to use retained earnings wisely.
- We do not see this long-term focus as eliminating the need for us to achieve decent short-term results as well. After all, we were thinking long-term thoughts five or ten years ago, and the moves we made then should now be paying off. If plantings made confidently are repeatedly followed by disappointing harvests, something is wrong with the farmer.[19]

Tony Russ and his team called The Value Group, at Shelby Cullom Davis in New York (NYSE members, etc.), have devised a "Management Report Card" and for four years have published their report card, applying it to 20 or so public companies in which they are interested. Each company is given a score for each sub-category.

The categories and the scoring are as follows:

MANAGEMENT REPORT CARD	
Category	**Possible Score**
Shareholder Democracy	
One share, one vote	10.0%
Defenses	5.0%
	15.0%
Act Like an Owner	
Compensation – cash vs. options	8.0%
Performance bonus	8.0%
Prerequisites	4.0%
	20.0%
Use of Owner's Earnings	
Dividend policy	5.0%
Economic value added	25.0%
Generation of net free cash	10.0%
	40.0%
Board Direction	
Independent managers' evaluation	5.0%
Shareholders' representation	5.0%
Restraint of dilution	5.0%
Shareholder communication	10.0%
	25.0%
Total:	**100.0%**

Source: The Value Group, Shelby Cullom Davis, New York

We think this management scorecard has plenty of room for improvement, but at least it is a starting point of something to work with. For example, we would add to the list large shareholdings by senior management and the Board as an important factor. In our experience, managers and directors with big stakes are more focused on long-term wealth creation. This is a real plus to the investors.

We view companies favourably that engage in share buybacks, if executed at favourable prices.

Also, small Boards generally seem more effective than large Boards and should be scored accordingly.

You might be interested in the score results of Shelby's list. Berkshire Hathaway received the top score (96) and Time Warner received the bottom result (28). In between, Shelby closely followed 18 other companies. Of note, Salomon Inc., Sallie Mae, Reebok and

Philip Morris all received very high scores on the Management Report Card, all of which – together with Berkshire Hathaway – are investments in the Burgundy Partners' Fund; all are also in the Burgundy Partners' RSP Fund, except for Sallie Mae.

Author: **Tony Arrell, Chairman and Chief Executive Officer**

December 1994

A Sure Fire Recommendation

Serious students of investing, and particularly those who share Burgundy's philosophy of investing in undervalued companies with superior fundamentals, should stop worrying about what to ask for as a Christmas present. We have a great suggestion. It is a book just released by Robert Hagstrom, Jr. entitled *The Warren Buffett Way*. We feel that it is the best book on investing that we have read in several years. Peter Lynch wrote a five-page Foreword to the book, offering his assessment of why Buffett is so successful as an investor, and this Foreword alone is worth the price of the book. Given that Buffett has accumulated a net worth of $8.3 billion through his investment activities, we think that a very careful study of this man and his methods is of vital importance.

The book offers many insights into Buffett and his thinking. An interesting chapter entitled "The Two Wise Men" suggests that Buffett is a product of two outstanding investors: Benjamin Graham and Philip Fisher.

Graham is considered to be the father of security analysis. He was a hardcore value investor who focused on asset value, and he was very statistically oriented. He invested in stocks that sold below their book value per share and favoured stocks that sold below their "liquidation value." (Basically, working capital less total debt, calculated on a per share basis.) Buffett studied under Graham in 1954-1956 while taking his Master's degree in Economics at Columbia Graduate Business School in New York, and he worked for Graham at his investment firm, Newman & Graham Corporation. It was here that Buffett refined his skills at analysis, with particular emphasis on the balance sheet. Watch out for an important new book on Graham by Janet Lowe entitled *Benjamin Graham on Value Investing*, soon to be released in New York. Warren Buffett is endorsing this book and is giving a rare speech on December 6, 1994 at the New York Society of Financial Analysts as a special tribute to Graham and to help launch the new book.

The second big influence on Buffett came from Philip Fisher, author of a very important book called *Common Stocks and Uncommon Profits*, originally published in 1958. Fisher also believed in buying undervalued stocks, but he defined value in a different way than Graham. He felt that the best investment results were obtained by investing in companies with strong potential to grow sales and profits. He placed important emphasis on the ability of a company to launch new products and on its research and development capability. He emphasized investing in low-cost producers with outstanding management. Fisher introduced the idea of circle of competence, which means investing only in companies that you really understand and can evaluate with confidence. He also believed in taking large positions in your best ideas, and in not overly diversifying. That way, you avoid having only superficial knowledge about a lot of companies.

In his book, Hagstrom has carefully reviewed Buffett's past investment decisions and he has tried to create a kind of checklist that Buffett uses when looking for companies in which to invest. Hagstrom divided the checklist into four categories:

1. Business Tenets:
   - Is the business easy to understand?
   - Is there a consistent financial history?
   - Are the future prospects of the company attractive?

2. Management Tenets:
   - Is management sensible, especially in allocating earnings retained in the business versus returning it to the shareholders by way of dividends or share purchases?
   - Is management candid with the shareholders in their reporting?
   - Is the management group resistant to the "institutional imperative"? Buffett sees the "institutional imperative" as a big impediment to business success. It is the tendency of company executives to imitate the decisions and behaviour of other managers, no matter how irrational they may be.

In the 1989 Berkshire Hathaway Annual Report, Buffett said that the institutional imperative exists when: "(i) an institution resists any change in its current direction; (ii) just as work expands to fill available time, corporate projects or acquisitions will materialize to soak up available funds; (iii) any business cravings of the leader, however foolish, will quickly be supported by detailed rate of return and strategic studies prepared by his troops; and (iv) the behaviour of peer companies, whether they are expanding, acquiring, setting executive compensation or whatever, will be meticulously imitated." [20]

How many companies can you name that suffer from the institutional imperative? We think that it's a long list.

3. Financial Tenets:
   - Return on equity is the key. This is more important than earnings per share.
   - "Owner earnings" – or what we at Burgundy would call "free cash flow" (net income, plus depreciation and amortization less capital spending for maintenance) – is probably the best reflection of economic value, as opposed simply to earnings.
   - Seek out companies with high profit margins!
   - Be sure that $1.00 or more of market value is created for each dollar of earnings that are retained by the management to reinvest in the Company. This is the concept of Economic Value Added (EVA), a tool we at Burgundy feel is very useful and that is gaining credibility in management circles.

4. Market Tenets:
   - What is the intrinsic value of the business?
   - Can the business be purchased at a significant discount to its intrinsic value?

In conclusion, *The Warren Buffett Way* is an unusually interesting and informative read.

Our Nation's Balance Sheet

The balance sheet of Canada as a country is very poor and it is deteriorating rapidly. One way to measure a country's balance-sheet strength is to measure the nation's total debt as a percentage of Gross Domestic Product (GDP). The following chart appeared in *Barron's* two weeks ago and we think it is worth a thousand words. The chart compares the debt as a percentage of GDP in the "Group of Seven" countries over the past 18 years, from 1977 to 1994.

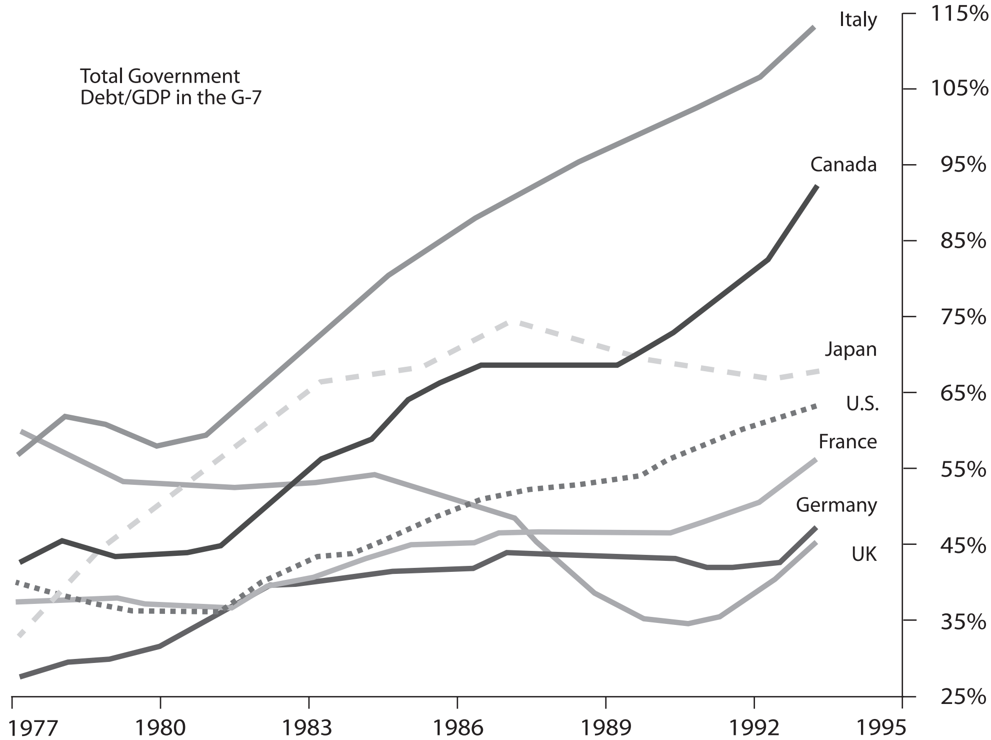
Take a minute to study the graph and note the following:

- Canada's debt currently is roughly equal to 95% of our annual GDP. As recently as five years ago it was 67%.
- Only Italy has a higher (worse) ratio than Canada.
- The slope of Canada's ratio (i.e., the rate of increase) is worse than Italy's in the past two years.

- The Group of Seven has all had a worsening balance sheet, except for the United Kingdom, which has improved materially, mainly during the Margaret Thatcher era.

DEBT RATTLE

High and rising debt/GDP ratios have had severe repercussions in bond markets and in the politics of countries deepest in hock.



Source: Barron's - OECD

Randall Forsyth, the author of the *Barron's* article, used the term "debt trap," and he defines the term as follows:

> "A debt trap occurs when a government's total debt equals roughly 80% of annual economic output. Though there is some debate about exactly when a debt trap is triggered, it is generally agreed to be in force when interest on the government's debt continues to rise even when the government's other spending is held in line with government revenues." [21]

Forsyth adds:

> "The Swedish and Italian examples demonstrate that financial markets can and will severely curtail governments' power of the purse. The U.S., to be sure, has enormous advantages over these countries. U.S. Treasury debt is all in dollars, which can be printed to cover these obligations. Greenbacks also remain the world's reserve currency and the preferred medium for international exchange. Sweden and Italy, by contrast, have borrowed heavily in nearly every foreign currency, which eliminates their ability to satisfy their debts with the printing press." [22]

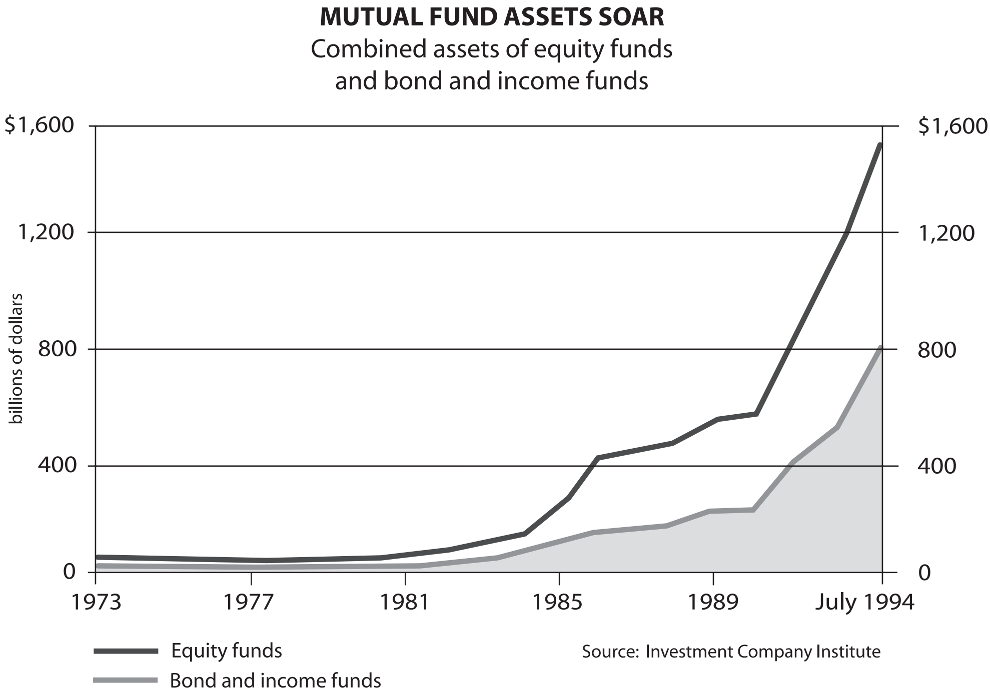
The *Bank Credit Analyst (BCA)*, a highly respected publication and observer of economic and financial matters, published a special article in July 1994 on Canada's debt situation. It noted that, "Canada's extreme levels of public sector and external indebtedness place it firmly in the ranks of the Third World in terms of debt burden." [23]

BCA believes that Canada has gotten to this high debt level because "international investors have continued to regard Canada as a reasonably good credit risk and their past willingness to buy Canadian debt (albeit with a large risk premium) has delayed the necessary and inevitable retrenchment." [24] BCA also points out the high debt level of the households and business sectors in Canada, which represented 127% of GDP at the end of 1993, compared to 98% at the end of 1983. According to BCA, household borrowing rose at twice the rate of disposable income during this period.

It is obvious to us that we have a serious problem in Canada. We are raising the issue not to alarm people, but rather to encourage and support tough action on the part of Paul Martin, who is certainly talking tough. We also present these facts as support for the very conservative approach to investments that we are following at Burgundy. This approach emphasizes undervalued companies with strong earnings; insures against significant market risk using "puts"; uses real rate of return triple A government bonds; and, where appropriate, invests in strong, undervalued companies outside of Canada.

The Mutual Fund Bubble

The chart below is from the Investment Company Institute in the United States and shows the growth of mutual fund assets over the past 20 years.



A few points seem noteworthy to us:

- Mutual fund assets have grown at astonishing rates since 1991. The line is nearly vertical. According to Ned Davis Research, 73% of the inflow into stock mutual funds since 1960 has occurred in the past three years.
- In 1993, equity fund assets grew by $226 billion or 43%, and bond assets grew by 32%. For the first time in a decade, assets of equity funds have overtaken those of money and income funds.

As James Grant said in an issue of his fine publication, *Grant's Interest Rate Observer*, "People have stopped reaching for yield and instead are buying for capital gains." [25] He points out that at the beginning of 1982, the public had almost 70% of its mutual fund assets in income funds.

No one knows what the future will hold. But we suspect that many of the recent buyers of mutual funds may lack the foresight and stomach for the inevitable volatility that will occur. A significant market drop could cause a big flow out of mutual funds with a dramatic impact on security prices.

This is additional argument for a conservative, value-oriented approach to investments.

Author: **Tony Arrell, Chairman and Chief Executive Officer**

1995 – 1999

1997

Hong Kong returns to China

East Asian financial crisis

1995

Rogue trader brings down Barings Bank

June 1995

The Great Investment Verities

We never cease to be astonished at how little time and effort is spent studying the key success factors behind the small number of truly great investors – both past and present – and their application to practical money-making investment decisions. Thousands upon thousands of high-IQ people-years, and reams of articles and extensive research studies by analysts, are expended forecasting quarterly earnings, the direction of interest rates, various aspects of the economy and earnings momentum. As well, countless further studies are made on various aspects of portfolio theory and portfolio construction.

Contrast this to the relatively limited effort by major institutional capital into understanding and applying the key success factors of these great investors. Warren Buffett explains this phenomenon as occurring because so many well-educated, talented analysts and investment people with so much computer power simply yearn to do more things in order to justify themselves and utilize their backgrounds. At Burgundy, we consider ourselves fortunate that relatively few investors have seriously studied these people and their approach; it provides far greater opportunity for us.

The truly great investors have achieved their success in different ways. Burgundy has distilled these key success factors into our own philosophy of investing, which is as follows:

- Invest in companies in which the estimated intrinsic value exceeds the stock price by a significant amount. This is what Ben Graham referred to as the "margin of safety."
- Invest only in companies you understand. This is Buffett's circle of competence concept.
- Invest in companies in which you have confidence in the management with respect to their honesty and competence. Examine in particular their capital allocation actions – when to pay out and when to retain.

Seek out managements that stress share price performance and return on shareholder's equity (ROE), rather than the absolute size of the company (many large Canadian companies fall into this trap of size versus per share progress).

- Pay careful attention to the quality of earnings, and the ability to generate free cash flow and its deployment.
- Seek out companies that have a strong competitive position or barriers to entry. If you don't have wide "moats" around your "grand castle," competitors will penetrate your territory, erode your profitability and eventually cause your downfall.
- Watch for brand names and natural oligopolies of various types. These are rare but extraordinarily valuable over time, especially if purchased when they are out of favour in the marketplace.
- Be a willing buyer of good companies when they are under pressure and when most investors are selling because of bad short-term news.

Ben Graham Tribute

On December 6, 1994, we attended a session at the New York Society of Financial Analysts entitled "A Tribute to Ben Graham." Ben Graham would have been celebrating his 100th birthday if he were still alive. Three of Graham's former students spoke at length: Warren Buffett, Irving Kahn and Walter Schloss, all very successful investors, with Buffett obviously being the best known of the three.

Buffett presented the basics of Graham's investment philosophy in a simple way:

> This is the 100th anniversary of Ben's birth, I believe. And on the creative side, if what I consider his three basic ideas are really ground into your intellectual framework, I don't see how you can help but do reasonably well in stocks. His three basic ideas – and none of them are complicated or require any mathematical talent or anything of the sort – are:
>
> 1. that you should look at stocks as part ownership of a business;
> 2. that you should look at market fluctuations in terms of his "Mr. Market" example and make them your friend rather than your enemy by essentially profiting from folly rather than participating in it; and finally
> 3. the three most important words in investing are "margin of safety," which Ben talked about in his last chapter of *The Intelligent Investor* – always building bridges that can carry 30,000 pounds but only driving 10,000-pound trucks across it.

> I think those three ideas 100 years from now will still be regarded as the three cornerstones, essentially, of sound investment. And that's what Ben was all about. He wasn't about brilliant investing. He wasn't about fads or fashion. He was about sound investing.
>
> And what's nice is that sound investing can make you very wealthy if you're not in too big a hurry. And it never makes you poor – which is even better.
>
> So I think that it comes down to those ideas – although they sound so simple and commonplace that it kind of seems like a waste to go to school and get a PhD in Economics and have it all come back to that. It's a little like spending eight years in divinity school and having somebody tell you that the 10 commandments were all that counted.
>
> There is a certain natural tendency to overlook anything that simple and important. But those are the important ideas. And they will still be the important ideas 100 years from now. And we will owe them to Ben...[26]

Capital Allocation

Capital allocation is one of those decisions that is so key to any business and yet so few companies do it well. At Burgundy, we believe that each business has an intrinsic return on equity (ROE) that investors are willing to pay for. The essential role of any CEO is to enhance or at least maintain that level of return to shareholders as the business environment evolves.

We have a simple concept of what that intrinsic ROE is: take the operating profit and divide it by the minimum capital it would take to maintain production. That number is what we believe should be the benchmark rate for the reinvestment of operating earnings (retained earnings). As long as the CEO continues to reinvest capital at or above that rate, the intrinsic value of the company will be maintained or enhanced.

The problem is that most CEOs are not paid according to the return to shareholders but in the growth of the business. Thus, if the intrinsic ROE of the company is 25% and the CEO acquires another business at 12%, he has grown the revenue of the company, but has reduced its intrinsic value.

Why is this so important? As long as companies continue to reinvest in their business at rates at or above their benchmark rate, they will enhance the market value of the firm and, most importantly, increase shareholders' wealth. A more difficult concept for corporate management to accept is that if they cannot reinvest capital at the corporation's benchmark rate, they should pay it out to shareholders either in the form of a dividend or share buybacks. Both methods enhance the market value of the firm to the shareholders, although arguably, share buybacks are a little more efficient since capital gains taxes are lower than taxes on dividend income.

While the market may not immediately reflect the decline in intrinsic value, especially if the capital is being reinvested internally at lower rates, over a period of five years or more the relationship becomes very clear. The way to measure the increase or decrease in intrinsic value is a concept called Market Value Added (MVA), developed by management consultant Stern Stewart, which shows the impact of capital allocation on the market value of a firm over time. The definition of MVA is the difference between the market value of a company at a point in time, plus the capital retained within the company over the period, compared to the current market value.

To illustrate the impact of capital allocation, we used two firms within the same industry, Rothmans and Imasco, which have taken very different views on capital allocation. In the charts shown on pages 58 and 59, the last column is a running balance of the MVA from 1985 to 1994. Beginning with 1985, the earnings retained for each year are added to the beginning market value and then subtracted from the current year's market value. The difference is the dollar amount of value the company has grown (or lost) due to the market's perception of the change in intrinsic value. It is MVA that best illustrates the reason why capital allocation is such a critical, in fact *the* critical, decision that any CEO makes.

Given the task of choosing between these two companies, many investors would look primarily at market share and profitability of the core products as the key factors. Ten years ago, if one had to choose between an investment in Rothmans or Imasco, the choice for most would have been Imasco for the following reasons:

- Imasco had grown its market share in the Canadian tobacco business from 35% to 65%.
- Two of Imasco's products, DuMaurier and Players, made up 55% of the tobacco market in Canada.
- In 1985, Imasco had operating profit margins (EBIT margin) of 17.6%, in a business where the government had essentially frozen the status quo by prohibiting competition among tobacco companies based upon price or advertising.
- In 1985, Rothmans was, and still is, a distant second in the business to Imasco. Profit margins (EBIT margin) in 1985 were 14.6% of sales, 3% below Imasco. Rothmans' return on equity in 1985 was only 9% versus Imasco's ROE at 17%.

Aside from moral or litigation issues, tobacco is a business whose only negative is the modest, but steady declining market as fewer people smoke each year. Because of this, and because it is not a high-tech business, the tobacco industry requires relatively little maintenance capital each year to generate high returns. This, combined with a highly profitable business, has meant that tobacco has been, and still is, an unbelievable "cash cow" for its owners. Since both companies were in the same business, Imasco was clearly the better company and the one that investors would have thought would provide the highest return to shareholders.

However, over the 10-year period from 1985-1994, Imasco's ROE has fallen slightly from 17% to 16%, while during the same period, Rothmans' ROE has vaulted from 9% to 40%. Profit margins have fallen at Imasco to 13% while Rothmans' margins have jumped from 14% to 34%. This startling reversal happened despite the fact that Imasco's market share in tobacco remains a dominant 65%.

The bottom line is that between 1985 and 1994, the total stock market value of Imasco went from $3.0 billion to $4.6 billion, a gain of $1.6 billion. This works out to a total gain over this period of 53% or only 6% per annum. The gain in market value of $1.6 billion is just about equal to the earnings retained by management during the period, which totalled $1.7 billion.

By contrast, Rothmans' market value was $226 million in 1985 and by 1994 its market value had increased to $460 million. The gain of $234 million in value compares to capital retained by management of about $288 million; however, three extraordinarily large dividends totalling over $400 million were paid out during the period, so that in fact $120 million of capital was extracted from the business on a net basis and paid to shareholders. Including the dividends paid, but not any reinvestment of those dividends, the total return to Rothmans' shareholders has been an impressive 27.4% per annum, compared with 8.1% for Imasco shareholders and 9.0% for anyone who simply held 91-day T-bills over the period.

Rothmans has taken the stance that tobacco provides the highest returns that it can achieve, but this industry requires little maintenance capital expenditures. The result has been that, since 1986, Rothmans has decreased the amount of capital allocated to the business from $11 million to $5 million or so annually. As less capital is tied up in the business, both operating profits and return on equity have soared and the excess cash generated by the business has been paid out in the form of large special dividends.

By contrast, at Imasco, the emphasis seems to have been to diversify and to grow the size of the company. Imasco has taken the substantial excess capital generated from the tobacco business and reinvested it primarily in Canada Trust, Shoppers Drug Mart and

Hardee's restaurants. While we at Burgundy believe that Canada Trust is one of the best of the Canadian financial institutions, it does not come close to achieving the returns of tobacco. Shoppers Drug Mart and Hardee's are both sub-par businesses in extremely competitive industries.

The incredible net result is that Imasco shareholders would have done better over the past 10 years by owning treasury bills in spite of being shareholders in a company that has a 65% market share in a highly profitable business.

At Burgundy, we see the relationship between reinvesting at a high rate and shareholder returns as being obvious, but some big public companies just don't seem to get it. We met with the management of Imasco a few months ago to talk about their business and especially their capital expenditures for 1995. We were astonished by the answer. For 1995, Imasco stated that it will commit $400 million of capital to its businesses; $40 million on its tobacco operations; $120 million on Shoppers Drug Mart (largely on a distribution system to help them fight against Wal-Mart and Zellers); and $100 million on building new Hardee's restaurants (to compete with McDonald's), which hopefully will start to turn a profit in two years.

Conversely, Rothmans has just declared an $8 special dividend on top of their normal $2, and not surprisingly, the stock rose to over $100 per share recently. Needless to say, Burgundy is a shareholder in Rothmans and not in Imasco.

ROTHMANS INCORPORATED

	ROE	Net Income Cont Ops	Net Income Disc Ops	Total Net Income	Common Divs Paid	Retained Earnings	Chg in Common Stock	Price	Shares O/S	Market Value	MVA
Mar 85	9.390	25.997	(1.705)	24.292	10.577	13.715	0.000	41.00	5,511	225.95	
Mar 86	(1.180)	14.236	(15.362)	(1.126)	10.547	(11.673)	0.000	35.00	5,511	192.89	-21.39
Mar 87	34.690	18.582	80.888	99.470	10.508	88.962	0.000	33.25	5,511	183.24	-120.00
Mar 88	12.720	30.378	0.000	30.378	230.910	(200.532)	0.000	39.50	5,511	217.68	114.98
Mar 89	23.390	33.701	0.000	33.701	10.454	23.247	0.000	62.50	5,511	344.44	218.48
Mar 90	23.850	40.394	0.000	40.394	12.616	27.778	0.000	68.00	5,511	374.75	221.01
Mar 91	28.460	43.318	0.000	43.318	102.924	(59.606)	0.000	55.00	5,511	303.11	208.98
Mar 92	36.540	49.305	0.000	49.305	21.946	27.359	0.000	94.00	5,511	518.03	396.55
Mar 93	34.370	55.327	0.000	55.327	22.043	33.284	0.000	101.00	5,511	556.61	401.84
Mar 94	40.090	58.654	0.000	58.654	121.235	(62.581)	0.000	83.50	5,511	460.17	367.98
Total						(133.762)	0.000	Change in Market		234.22	
Total Return	**(41.000)**	**1.600**	**1.600**	**41.598**	**1.600**	**2.000**	**18.399**	**3.700**	**4.000**	**105.499**	
27.43%											

Source: Burgundy Investment Team Research

IMASCO LIMITED

	ROE	Net Income	Div Paid	Retained Earnings	Chg in Common Stock	Price	Shares O/S	Market Value	MVA	
Dec 85	17.319	261.745	78.700	183.045	0.300	13.938	217.816	3,035.92		
Dec 86	11.209	212.646	102.900	109.746	349.100	16.250	238.246	3,871.50	376.73	
Dec 87	12.003	245.029	129.500	115.529	1.500	12.938	238.382	3,084.19	-527.61	
Dec 88	15.293	314.310	139.100	175.210	0.000	14.000	238.382	3,337.35	-449.66	
Dec 89	16.238	366.100	157.800	208.300	1.100	18.875	238.494	4,501.57	505.17	
Dec 90	12.326	291.400	179.600	111.800	0.100	13.812	238.226	3,290.38	-817.93	
Dec 91	13.267	331.600	179.000	152.600	2.200	18.250	238.228	4,347.66	84.56	
Dec 92	14.078	380.400	189.000	191.400	5.000	20.625	238.198	4,912.83	453.33	
Dec 93	13.893	409.000	197.000	212.000	4.000	20.062	238.374	4,782.26	106.75	
Dec 94	16.110	506.000	196.000	310.000	(16.000)	19.875	233.482	4,640.45	-329.05	
Total				1,586.585	347.000	Change in Market		1,604.535		
Total Return	**(13.998)**	**0.432**	**0.543**	**0.584**	**0.662**	**0.754**	**0.751**	**0.793**	**0.826**	**20.714**
8.07%										

Source: Burgundy Investment Team Research

Authors: **Tony Arrell, Chairman and Chief Executive Officer**
Stephen Mitchell, Senior Investment Analyst

August 1995

Errors of Omission

Readers of *The View from Burgundy* are perhaps aware of the importance we place on the principle that shareholders are owners of fractions of a business, rather than builders of abstract portfolios. In this issue, we explore once again the implications of that ideal as it applies to capital allocation.

A little thought on the subject yields some simple, but radical insights. If we are owners, we must concern ourselves with the management of the business. As shareholders, the ultimate test of our interests must be long-term return on our capital. Therefore, we have not only the right, but also the duty to insist that management decisions be made with this paramount interest in mind. When we see wasteful behaviour, we must oppose it vigorously.

Unfortunately, such behaviour is not uncommon, particularly in Canada. Some companies sit on huge cash hoards for years, earning only modest returns while waiting for acquisition opportunities that seldom materialize. Even worse, some managements go on buying binges with shareholders' money, undertaking the dolorous process that Peter Lynch characterizes as "di-worse-ification": the buying of inferior businesses with the cash generated by superior ones, or overpaying for them – a very common fault.

Many corporate managers have a strong bias against returning cash to the owners of the business, whether through share repurchases or special dividends. They consider such actions to be an admission of failure of will or imagination. But they are not entirely to blame. Most often, Canadian shareholders fail to demand that management's primary focus be shareholders' interests. Thus, some Canadian companies act like "institutions" rather than economic entities, and Canadian shareholders are treated to the spectacle of various exploits in the wastage of their wealth.

In theology, two types of transgressions are recognized. The first is the "errors of commission," where wrong actions are deliberately undertaken. The other is the "errors of omission," which are failures to act when right actions are necessary.

In our last issue, we examined the "errors of commission" of Imasco Ltd., a very decent Canadian company whose management decided years ago to take the reinvestment of shareholders' money out of their hands, and to embark on a diversification program that has diluted the returns generated by its lucrative core tobacco business. In this issue, we look at the "errors of omission" of a prominent Canadian company that has been sitting on a growing cash hoard for over a decade without either returning it to shareholders or making acquisitions. Unhappily, there are several such companies in Canada, and one of the best examples is Moore Corporation.

A leader in a declining business, Moore Corporation is the world's largest manufacturer of business forms. This was a wonderful business as recently as the early 1980s, when Moore regularly earned a return on equity (ROE) of nearly 20%. At that time, the proliferation of computers led to a vast upsurge in the usage of business forms. Clients tended to inventory their business forms, which were often custom designed. As a result, Moore had an enviable return on its fixed assets and inventories, and its relatively low maintenance capital expenditures meant that it was a good, reliable free cash flow generator. Steady dividend increases were the norm.

Entering the mid-1980s, Moore was a cornerstone investment in many Canadian equity portfolios, as a non-cyclical Canadian multinational of great financial strength. While its ROE had been dropping steadily since the early 1970s, the company still compounded its equity at around 15%, which was quite respectable. Farsighted analysts were predicting a maturing of the business forms market due to competition from new electronic technologies, but the process was occurring slowly. The firm's stock had a fine run with the rest of the business services stocks in the 1985-1986 period, and again in the post-1987 crash period, when it reached its all-time high of close to CAD $40 per share.

At that point, a deteriorating economy and an increased willingness among traditional business forms users to use Electronic Data Interchange (EDI) in billing and ordering systems caused a rapid downturn in Moore's performance. Profits entered a four-year slide, culminating in the appointment of a new President and CEO, Reto Braun, from outside the firm, as well as several write-downs and some discontinued product lines. The new management group made a couple of moves, buying an interest in a small business forms software firm, and then selling its Japanese subsidiary for a hefty price. They have moved decisively to cut costs, reduce labour and close some plants.

So that's Moore Corporation in a nutshell over the past 15 years or so. It's not an uncommon story for a maturing company. So what is it that is so offensive to shareholders? The answer, as in the case of Imasco, is capital allocation. Based on the figures in the table on page 65, Moore's return to shareholders over the past 10 years to December 31, 1994 is an extraordinarily low 3.4% compounded annually, and this during one of the greatest bull markets in history. Market Value Added has been negative $337 million over the past 10 years.

Moore earned this very low return despite generating free cash flow in most years. Between 1990 and 1993 the company had taken $475 million in write-offs – the cash effects of which are unclear – so our chart in fact may be understating free cash flow. We include a column showing the value of cash and marketable securities held by Moore each year to show exactly where the money has gone – into the bank. Without stock buybacks or large dividend payouts, Moore's cash and marketable securities have ballooned to $374 million or $3.76 per share. Not only that, the company issued 10 million shares through a dividend reinvestment program between 1985 and the end of 1992, despite its debt-free position and strong cash flows! That kind of nonsense has mercifully been discontinued, but not before Moore's shareholders, in an incredible abdication of responsibility, allowed the management to adopt a poison pill provision in 1990, which was updated and confirmed at Moore's Annual General Meeting held on April 27, 1995.

In their comments in the information circular prepared for the 1995 AGM, the Board stated that, "Rights plans have been a valuable tool in enabling Boards of Directors to enhance shareholder value in the face of unsolicited takeover bids."[27] We thought to ourselves that the company's shareholders might have been better served if the Board were encouraging takeover bids, not discouraging them. Nevertheless, the plan was confirmed.

It's a fact that Canadian managements are not held to a very high standard in their capital allocation decisions. Shareholders have been content with being overlooked when it comes to managements' allocation of excess cash. They acquiesce to initiatives by undeserving managements who entrench their interests, and consistently re-elect directors who have failed to insist on maximization of shareholder value as the primary goal of a public company.

Moore's Board is one of the most institutionalized in corporate Canada. Although a good Board of Directors needs a leavening of experience, no less than five of the nine members of Moore's board are retired executives and six are over age 65. Only two directors own more than 1,000 shares of company stock: Ed Crawford, a director for 20 years, owns 10,431 shares and Reto Braun, the new CEO, owns 12,399 shares. (Mr. Braun also had an option to acquire an additional 60,000 shares within 60 days, which was included in his shareholding in the 1995 Management Information Circular.) The remaining seven directors own less than 1,000 shares, a minor economic interest indeed, probably less on average than they would have invested in their personal car.

Moore's reason for its unconscionable cash hoard has always been an imminent acquisition. However, any such acquisition has thus far eluded the company so the shareholders' cash still sits there after 10 years, awaiting a management with the vision and shareholder orientation to either make a wise acquisition at a favourable price, or to give it back to its rightful owners. Mr. Braun and his new team at Moore may be the ones to do it; at least, we certainly hope so.

[Note: A few days after the final draft of this issue of *The View* was prepared, Moore announced that it was making an unsolicited bid for Wallace Computer Services Inc. at US$56 per share or $1.3 billion in total. Maybe this will be a huge merger for Moore Corporation – we certainly hope so. We note that the proposed purchase price is roughly equal to the shareholders' equity of Moore Corp. so a lot is at stake.] [28]

A few facts on Wallace give us some apprehension:

- Moore is offering $56 per share or US$1.3 billion in total, while only six months ago, in a bull market, Wallace's stock price was $30, and it hit a high of $41 just prior to the takeover announcement.
- The earnings per share for Wallace have been $1.84 (1993), $2.13 (1994) and $2.35 (1995 estimate), so the price/earnings ratio based on 1995 (estimate) is 24 times the price Moore is offering.
- The book value per share is $18.32, making the offer three times book value. The return on shareholder equity has been 11.1% (1992), 11.2% (1993) and 11.5% (1994).
- The offer is at roughly two times Wallace's sales.
- The five-year high/low on Wallace prior to Moore's offer was $41 and $19 per share. We certainly hope that Moore's management and Board compared the merits of buying back their own stock as an alternative to the proposed acquisition. Moore's own shares by comparison are selling at roughly 1.5 times book value and 16 times earnings.

MOORE CORPORATION LIMITED
(C$)

	ROE	Net Income	Div Paid	Retained Earnings	Chg in Common Stock	Cash & Mkt Sec	FCF/ Share	Shares Out'g	Price	Market Value	MVA
Dec 85	16.05	191.12	88.43	102.69	27.63	213.68	1.25	89.93	28.13	2,529.31	0.00
Dec 86	11.49	151.32	90.03	61.29	27.42	244.62	0.66	90.93	28.88	2,625.72	7.70
Dec 87	13.50	190.20	88.10	102.10	19.60	586.93	1.67	92.01	26.00	2,392.23	-224.90
Dec 88	15.12	221.78	86.15	135.64	9.21	314.73	2.03	93.05	30.63	2,849.66	87.67
Dec 89	14.76	233.69	95.70	137.99	33.32	320.35	1.75	94.35	33.25	3,137.10	285.42
Dec 90	8.10	139.36	103.44	35.92	45.11	322.52	0.38	95.81	25.75	2,467.21	-398.42
Dec 91	5.64	101.36	104.97	-3.61	50.48	307.83	0.66	97.74	24.75	2,419.16	-488.63
Dec 92	-0.15	-2.96	118.33	-121.29	78.88	396.51	-0.11	99.47	21.88	2,175.88	-893.64
Dec 93	-5.57	-102.57	123.61	-226.18	18.19	345.94	-1.00	99.52	25.50	2,537.86	-402.73
Dec 94	9.07	170.18	131.16	39.02	28.03	374.09	1.76	99.57	26.75	2,663.50	-336.91
Total				**160.870**	**310.231**			**Change in Market**		**134.188**	

Source: Burgundy Investment Team Research

Market Value Added (MVA)

The concept of MVA is testing whether $1.00 retained (or raised) by a corporation adds $1.00 or more of added wealth to the shareholders. If MVA is positive, it means that management is increasing the net worth of its shareholders by retaining earnings for reinvestment.

The formula is to measure the change in market value of a company over time (in Moore's case, 10 years) and to compare this to earnings retained plus new equity raised. In Moore's case:

MVA = Change in market value – (equity capital retained + amount raised)

= (2,663 – 2,529) – (161 + 310)

= –$337 million

Diversification

We attended a December 6, 1994 special meeting of the New York Society of Financial Analysts where a discussion/debate broke out between Walter Schloss, Warren Buffett and several members of the audience on the subject of diversification of investments. Both Schloss and Buffett are outstanding investors, and as young men both were employees of the great Ben Graham. Buffett pointed out that some of the world's greatest fortunes have been made from an investment in a single "wonderful" company. He feels there are a very limited number of "wonderful" businesses in the world and that it is quite a good position to own a piece of a half-dozen of them. Schloss on the other hand has owned hundreds of stocks, and has a terrific record over 40 years. He referred to this method as the "used cigar butt approach." Schloss feels that almost anything is a buy at a price.

At the meeting, Buffett stated the following on diversification:

> Well, the less you know, the more stocks you have to own – because diversification is a protection against... ignorance. And if your only conviction is that equities over time are a good place to have your money, you probably ought to have at least 20 or thereabouts – I'm talking about stocks, not mutual funds, which in turn own stocks themselves.
>
> But if you really analyze businesses so that you're buying into a business and making a conscious decision about what you think the future of that business is – not just a general conviction about equities as a whole, but conviction about a specific business and the future of that business in the same way that you'd go out and buy a grocery store or a filling station in your own home town – then I really think that if you can find six or eight of those, well that's plenty.
>
> Our method is very simple. We just try to buy businesses with good to superb underlying economics, run by honest and able people and buy them at sensible prices. That's all I'm trying to do.
>
> But that means I have to understand the business. And that leaves out 90% of all businesses. By definition, there are all kinds of things I'm not going to understand – I don't understand cocoa beans or all kinds of other things. But the only thing that counts is the pitch you swing at.
>
> If you can find a universe of 50 companies where you think you may understand their business and then find half a dozen that look properly priced, that's plenty.
>
> All I can tell you is what I do basically – and that's to try to figure out what a business is worth. It's exactly what I would do if I were going to buy a Ford dealership in Omaha – only with a few more zeros. If I were going to try and buy that business – let's say I weren't going to manage it – I'd try to figure out what sort of economics are attached to it: What's the competition like? What can the return on equity likely be over time? Is this the guy to run it? Is he going to be straight with me?

> It's the same thing with a public company. The only difference is that the numbers are bigger and you buy them in little pieces.[29]

At Burgundy, we look for superior businesses to own for the long term. In the Canadian market, where such businesses are rare, we own them when we can. For the rest of the Canadian portfolio, we look for companies that are significantly undervalued. We do our homework, visiting management and doing our best to understand the business. Our portfolios typically contain 25-35 names, which is much more concentrated than most Canadian investment managers. The stocks we own are not cigar butts, but they are definitely not always of Coca Cola Corporation's calibre either.

In the U.S., there are more opportunities to own great companies. We try to avail ourselves of these opportunities and in the Burgundy Partners' Fund, for instance, we rarely own more than 20 companies.

To some extent, owning 20 to 30 stocks is a protection against not being Warren Buffett. Ignorance is something we can guard against by diligent research, but not having the insight of this great genius is nothing to apologize for.

Author: **Richard Rooney, Senior Vice President and Chief Investment Officer**

December 1995

Doing It Right

In previous issues of *The View from Burgundy*, we justifiably have tended to be hard on managements that have failed in what we consider to be arguably their primary function: to allocate capital produced by the business in ways that will create shareholder value. We reject woolly notions of "stakeholders" who have a prior claim on company policies or wealth and we confidently assert the following truth to be self-evident: that a company which successfully rewards its shareholders over a long period of years will also be a company that delivers to these "stakeholders" what they want: namely, safe jobs for employees, steady taxes for governments and a clean environment for the general public.

In order to provide our readers with examples of companies that operate in the shareholders' best interests, we wish to highlight two such companies that have found different ways of doing it right. In the U.S. market, we will look at Philip Morris – a superb company – while in Canada, we will examine recent developments in a small Alberta company – Intera Information Technologies. The examples are quite different, but nonetheless instructive.

Philip Morris (US$94) is one example of a tobacco company whose diversification strategy has not been a pure "weed-watering" exercise. With the most powerful tobacco brands in the world generating the phenomenal cash flows and returns on capital characteristic of this business, Philip Morris years ago bought Miller Brewing, Kraft Corporation and General Foods, which were also great businesses. The company is now a brand name powerhouse, with 66 products each generating over $100 million in annual sales. Its markets are stable and its profits highly predictable.

As if this embarrassment of riches wasn't enough, the company is run by a management headed by Geoffrey Bible that has rewarded shareholders for holding Philip Morris stock. The company has increased its dividend on average every nine months for the past 20 years. Compound dividend growth per share has been 22.8% over 10 years. Over the last decade, return on equity (ROE) has averaged over 30% and cash flow has grown by a stunning compound 17%. Because of this plethora of cash, the company has been able to buy back

$5.6 billion worth of its own stock (over five years), which has in turn greatly increased the per share values in the company. It doesn't get a lot better than this.

Intera is a smaller example of a Canadian company that shows what can happen when a management decides to stop "watering the weeds" and realize shareholder value instead. Intera had two businesses, one good and one bad. The good business was a software product for modelling reservoirs of oil and natural gas. The product was the best in the business and had a large market share, high margins and strong cash flows. The other business was an aerial mapping business that was perennially in the red and relied on spotty government contracts to stay in business.

The strength of the software business was overwhelmed by the weakness of the aerial mapping business, and the stock market history of Intera was a grim one since its IPO in 1990. By June of 1995, the company's stock was under $3, or about half book value. A new management team was in place, substantial write-offs had been taken and a fresh approach was obviously called for.

Management decided that the shortest difference between two points was a straight line. They announced that they were going to sell off the company's assets and distribute the proceeds to shareholders. From a low of $2.45 in early June, the stock popped to $13 in a few weeks when the software business was sold for about US$10 per share. One analyst's estimate of the ultimate distribution to shareholders is US$15 per share, or CAD$20. If the process is complete by mid-year 1996, and this analyst is correct, the management will have rewarded shareholders with a one-year return of over 700%.

Unfortunately, we must add that the trading in Intera stock immediately before the announcement of the liquidation is currently being investigated and there are allegations of stock manipulation. We do not consider these issues central to our discussion, since the returns from the liquidation strategy were so huge that, even had the stock been trading at $10 before the announcement of liquidation, the decision was still clearly right.

Our point is that there are huge returns available from managements and majority shareholders who are willing to reverse the old "di-worse-ification" practices of using free cash flow from superb business to invest in inferior business and focus, privatize or liquidate their businesses. The malaise of the Canadian stock market since 1981, we believe, in part reflects the inadequate returns on capital that corporate Canada has been able to generate in that period. In the competitive world of the 1990s, Canadian companies can no longer afford to allocate their capital poorly.

Capital Punishment – Canadian Equities From the Bottom Up

The enormous underperformance by the TSE 300 compared to the S&P 500 (or any other U.S. market index) has led to a variety of explanations and rationalizations over the past five years. Some blame Canada's fractious, puerile politics, while some blame deficits, debt and taxes. No doubt there is some truth in these viewpoints, but we suggest that the nub of the problem is capital allocation. You thought Canada didn't have "capital punishment"? Check out these statistics derived from an extensive research project conducted by Burgundy's Allan MacDonald.

At Burgundy we make extensive use of a database called "Stock Guide," which has a large amount of financial information on almost all public Canadian companies listed on the Toronto and Montreal Stock Exchanges. At the moment, there are roughly 2,000 stocks in the Stock Guide database. Of these companies, 728 were public at the beginning of 1990, with the balance added thereafter, presumably reflecting the boom in IPOs of the early to mid-1990s. All of the statistics mentioned in this article are based on these 728 public Canadian companies.

We were astonished by both the absolute number of companies that had made a cumulative pre-tax loss in that five-year period, and by the magnitude of the losses incurred. Of the 728 stocks screened, 280 companies – or 38% of the sample – as a group lost an incredible $21 billion in total during that five-year period. The losses represented 66% of the $32 billion in common equity these 280 companies had at the beginning of 1990. There were several major components of this catastrophic record; of the top-20 money losers, the major contributors were:

- $4.7 billion in losses from forest products companies, namely Avenor, Domtar, Repap, Abitibi and Noranda Forest
- $3.1 billion in losses from the unravelling of the real estate boom of the 1980s in Bramalea, Gentra (Royal Trust), Harrowston (First City) and Tridel
- $2.1 billion in losses from the two Canadian airline companies
- $1.2 billion in losses from Stelco and Dofasco

Critics may assert that these numbers include many write-downs of assets by managements in this period that do not impact cash flow. We respond that the write-offs are the result of past capital allocation decisions that obviously didn't work out. This is not to say that management action could have averted these losses. On the contrary, the economics of some of these businesses are so poor that the best management in the world could not really have much impact on cyclical profitability. In Warren Buffett's words, "When a management with a reputation for competence takes on a business with a reputation for bad economics, it is the reputation of the business which remains intact." [30]

What we find peculiar is that Canadian shareholders, who are either very forgiving or suffering from "cyclical amnesia," have been more than willing to replenish the denuded capital cupboards of these 280 companies during the new issue boom in equity markets. Who can forget the billions of equity that were pumped into the balance sheets of capital-intensive commodity cyclicals in the 1992-1994 timeframe? On average, the number of shares outstanding of these 280 companies increased by 66% since January 1, 1990. We wonder about the future returns on this new capital. The stock market is perhaps giving us some indication, since the average price to December 31, 1995 of these 280 equities declined by 6% in the five-year period ending December 31, 1994.

Now let's look at the other end of the spectrum – the companies that did not experience a single down earnings year in that five-year period. There are (alas) only 59 of them, but what a group of stocks! They produced $22.8 billion in pre-tax earnings. And the stock market returns were glorious – the median stock in the group returned 185% over five years.[31] It would be hard to find more compelling evidence of what we might call "the power of positive earnings." Admittedly, these 59 stocks are the elite of the elite, and the chances of having a whole portfolio of stocks in Canada that do not experience a drop in earnings during a recession is pretty small. But most of these stocks are the acknowledged cream of the crop in Canada – well-managed firms like Bombardier, Rothmans, Renaissance, Linamar, Cinram, Primex and Euro-Nevada, to name but a few from a variety of industries. The encouraging thing about this list of companies is that it includes names from capital-intensive industries like oil and gas, manufacturing, and forest products. But each has a specific competitive advantage: Bombardier – its uncanny ability to buy assets so cheap that the capital-intensive nature of its business is neutralized; Renaissance – its extraordinary focus; Primex – its lack of timberlands tying up capital. It goes without saying that all these companies are superb operators of their day-to-day business.

Cyclicals are heavily represented in the TSE 35, which, whether they admit it or not, is the core portfolio of the big Canadian money managers. These companies currently account for almost 21% of the TSE 35. In fact, no fewer than 15 of those 35 stocks have shown a pre-tax loss at least once in the 1989-1994 period. If you manage with reference to an Index, you end up "overweighting" or "underweighting." If investing, you only play these companies when they are selling far below their intrinsic values at cyclical lows.

(The evidence so far suggests that for the airline industry, the intrinsic value of the stocks in a deregulated market is zero.) If an investment manager owns these stocks through thick and (mainly) thin, "investing" is not an apt description of his or her activities; "indexing" is more exact.

At Burgundy, we try to be very selective about which cyclicals we invest in, and when. We suspect our weighting in the cyclicals is currently below that of almost any other Canadian money manager, and we expect this situation to continue until the next cyclical trough in these stocks. The reason is that we don't care what the Index says about weightings; we only care what value techniques say about our investments. And for a value investor, the word on cyclicals is "caveat emptor": let the buyer beware.

At Burgundy, we are always talking about buying great companies at reasonable prices. Great companies, as we have defined, are companies with high ROEs, high free cash flow (cash from operations minus ongoing capital expenditures) and high barriers to entry.

The obvious examples of these kinds of companies are Philip Morris and Dun & Bradstreet. But astute observers of our portfolios have also noticed our strong interest in Property and Casualty (P&C) insurance companies. Since the value of these firms is not as obvious, we thought that we would explain some of the simple characteristics that can make these companies great.

A P&C company is really two separate businesses: one is the underwriting or operating line of the company that generates the cash flow or float, and the second is the investment management that manages the float within the confines of the payout requirements.

The underwriting business is the basic component of the industry, and the part of the business that most people focus on. The basic measure of this part of the business is the combined ratio, which is the sum of expense ratio (how much does it cost you to write the business) plus the claims ratio (how well did you price the business). If the combined ratio equals 100, then the underwriting broke even; if it is greater than 100, then the underwriting side of the business had a loss.

In 1994, the industry average expense ratio was 32.8% or $0.33 for every premium dollar written. A large part of this cost is the commission that is paid to the insurance broker for booking the business. Direct sellers, such as GEICO in the U.S. and Direct Line in the U.K. have expense ratios of 18% and 15%, respectively.

The claims ratio is a measure of how well management has priced the product. In 1994, the industry average was 75.0% or $0.75 of every premium dollar written. Because many managements are measured in part by how much business they have written, the temptation is always there to lower the cost of the insurance to attract more business. This is especially true when the industry itself is under pressure. Where managements add value is by actually turning away business that will generate underwriting losses instead of just building the book.

The industry average combined ratio in 1994 was 107.8%, or the average firm lost $0.08 for every premium dollar written. In that year, Fairfax Financial Holdings had a combined ratio of 104.0% and Kingsway Financial Services, a recent investment of ours, had a combined ratio of 93.9%.

The second component of the P&C company is its investment management. The float generated by the premium income is invested either in bonds exclusively or in a combination of bonds and equities depending upon the regulation of that firm and its requirement for liquidity. In the case of Fairfax in 1994, the value of the float equalled $173.25 per share versus the book value of $43.77 per share. This implied leverage means that Fairfax's return of 4% on investments can be translated into a 16% return on shareholders equity (= 173.25/43.77 = 4.0; 4 x 4% = 16%).

Due to Fairfax's emphasis on long-term investing and equities, management have been able to grow the book value of the firm at a compound rate of greater than 40% over the last 10 years. Growth in book value is particularly important for these types of companies because the unrealized gain or loss on their investment portfolio is reflected in their book value and not in earnings.

The final measure is ROE. In 1994, Fairfax's ROE was 12.1%, Kingsway's was 21.9%, while the industry average was 7.9%. Over the last five years, the average ROE for Fairfax has been 16.9%, for Kingsway 26.1%, while the industry average was 9.1%.

Frictional Costs

There are many types of costs to managing a portfolio. The one that is probably least understood is the question of trading and "frictional costs." In an effort to keep the quarterly return numbers high, many investment houses are constantly in and out of the market, looking for the next great buy and selling as soon as they have made a certain percentage gain. Their numbers look great, but after the investor has paid the taxes on these capital gains, did they really do that well?

To illustrate this point, suppose you took $1 million and invested this money with a portfolio manager who had excellent results but turned over the portfolio once every year. As well, the money to pay for the tax bill had to come out of the portfolio. Also assume that your tax rate is 52% and that your capital gains tax rate is 39%. If your investment manager is incredibly good and makes you 20% return every year, your portfolio would grow as follows:

	Year 1	Year 2	Year 3	Year 4	Year 5
1.	$1,000,000	$1,122,000	$1,258,884	$1,412,468	$1,584,789
2.	200,000	224,400	251,777	282,494	316,958
3.	(78,000)	(87,516)	(98,193)	(110,173)	(123,614)
4.	$1,122,000	$1,258,884	$1,412,468	$1,584,789	$1,778,133

1. Invested capital
2. Investment return
3. Taxes paid
4. Reinvested capital

While your investment manager has done an excellent job in increasing your net worth from $1 million to $1.778 million in five years, your actual return has been only 12.2%. Put it another way, if you had left your money in companies over the same period and never sold them until Year 5, they would only have to increase in value by 12.2% annually to equal the same result as your 20% annual trading return.

Simply said, this is why we like to invest in great companies that we can hold for a long time, and indeed why returns across different types of investment managers are not as readily comparable.

Authors: **Richard Rooney, Senior Vice President and Chief Investment Officer**
Allan MacDonald, Senior Investment Analyst

March 1996

Capital Punishment Part II

In our December 1995 issue of *The View from Burgundy*, we shared with you some interesting data regarding the 728 Canadian public companies in the Stock Guide database for fiscal year-ends closest to the five-year period January 1, 1990 to December 31, 1994. In that article, we pointed out that roughly 38% of the 728 companies lost money in aggregate over the five-year period. We also noted that a small number of the companies – 59 of them – had been able to improve results each year during the survey period. We referred to these companies as "the cream of the crop" and pointed out that this small elite group, making up only 8% of the sample, had experienced a median 185% appreciation in stock market value in that period.

Following its publication, a number of our readers contacted us seeking a list of the 59 companies or asking if some of their particular favourites were on the list. So in response to the demand, we list below the 59 elite companies in declining order of their market capitalizations:

Barrick Gold Corporation
Bank of Montreal
Bombardier Inc.
Imasco Limited
Newbridge Networks Corporation
Potash Corporation
Magna International Inc.
Renaissance Energy Ltd.
BCE Mobile Communications
BC Telecom Inc.
Investors Group Inc.
Franco-Nevada Mining Corp.
Canadian Natural Resources Ltd.
United Dominion Industries Ltd.
Loewen Group Inc.
Euro-Nevada Mining Corporation
London Insurance Group Inc.
Rothmans Inc.
Goldcorp Inc.
Metro-Richelieu Inc.
Chauvco Resources Limited
SR Telecom Inc.
Cinram Ltd.
Trimac Limited

Maple Leaf Foods Inc.	Uni-Select Inc.
Morrison Petroleums Ltd.	Lassonde Industries Inc.
Linamar Corporation	Hartco Enterprises Inc.
Tarragon Oil & Gas Limited	Schneider Corporation
Quebec Telephone	Electrohome Limited
Fortis Inc.	ADS Associates Limited
Unican Security Systems Ltd.	Richmont Mines Inc.
Pinnacle Resources Ltd.	Maax Inc.
Rio Alto Exploration Ltd.	Maxx Petroleum Ltd.
Sceptre Investment Counsel Ltd.	GSW Inc.
Acklands Limited	Premier Choix: TVEC Inc.
Winpak Limited	Primex Forest Products Ltd.
Jordan Petroleum Ltd.	Samoth Capital Corporation
Dorset Exploration Ltd.	Intermetco Limited
Domco Industries Limited	Foremost Industries Inc.
Gennum Corporation	Goodfellow Inc.
Northrock Resources Ltd.	Logibec Groupe Informatique
Transat A.T. Inc.	

A few observations about the list are in order. First, it is a rather one-dimensional view, taking a short period of time (five years) and concentrating on only one variable – namely, increasing pre-tax income. The period is short enough that there may be some companies whose cyclical uptrend coincided with the survey period. The presence of no fewer than 11 oil and gas producers would tend to be a tip-off that we should extend our survey period to see what happened to our sample in 1995.

We find the presence of 15 Quebec-based companies interesting. We have found a lot of cheap stocks in Quebec of late (no surprise, under the circumstances) but our work in this survey has revealed a lot of very high-quality companies as well. We would venture that firms like Bombardier, Domco, Hartco, Lassonde, Maax, Metro-Richelieu, Premier Choix, SR Telecom, Uni-Select and Unican have managements that compare favourably with any others in their industries. We feel that management makes an enormous difference and there appear to be many good managements in Quebec.

Those who consider Toronto to be the centre of the Canadian business universe might ponder the extreme scarcity of Toronto-based companies on this list, compared to the city's preponderance of head offices in the country. There are quite a few Ontario-based companies represented, but they tend to be the kind of firms where the management lives "over the store," like Linamar in Guelph or Newbridge in Kanata. Often, the Toronto companies on the list do not have a downtown address, such as Cinram and Acklands.

Specific outstanding business opportunities have placed clusters of stocks on the list. Thus, we see the Carlin Trend in Nevada giving us Barrick Gold, Euro-Nevada and Franco-Nevada. Unsurprisingly, both of Canada's public plays on tobacco, Imasco and Rothmans, are represented. The Canadian money management companies that were public throughout the period and whose performance did not stumble were Investors Group and Sceptre Investment Counsel. (Trimark went public only in 1992, otherwise it would certainly be on the list.)

We decided to further winnow the list in hopes of coming up with a few truly outstanding companies on which to focus. An obvious way to cut down the number of stocks was to eliminate those companies that had started the survey period in a loss position. (Remember, our survey included companies that had improved pre-tax results every year, even if they started from a loss.) We then carried forward our survey to the latest reported earnings in 1995 to eliminate companies whose string of earnings increases ran out in that year.

The result of our screen was the following list of 27 "super-elite" stocks:

Barrick Gold Corporation
Bank of Montreal
Bombardier Inc.
Imasco Limited
Potash Corporation
Renaissance Energy Ltd.
BC Telecom Inc.
Investors Group Inc.
Franco-Nevada Mining Corp.
Loewen Group Inc.
Euro-Nevada Mining Corporation
London Insurance Group Inc.
Metro-Richelieu Inc.
Cinram Ltd.
Linamar Corporation
Quebec Telephone
Fortis Inc.
Unican Security Systems Ltd.
Sceptre Investment Counsel Ltd.
Winpak Limited
Domco Industries Limited
Gennum Corporation
Uni-Select Inc.
Lassonde Industries Inc.
Maxx Petroleum Ltd.
Premier Choix: TVEC Inc.
Samoth Capital Corporation

As we had suspected, the 1995 price swoon in oil and gas removed nine of the eleven oil and gas companies from the list. No one will be surprised to see Renaissance Energy, that paragon of an energy company, still on the list, and we are sure a lot of our readers will want to take a closer look at Maxx Petroleum. We certainly will.

It is encouraging to see a fairly wide dispersion of industries represented in this super-elite group of stocks. Tobacco is represented, of course, as is the Carlin Trend group and the money managers, but we also see heavy industrials like Bombardier, niche manufacturers like Cinram and Winpak, and companies from insurance, food retailing, auto parts distribution, potash mining, and banking and finance. Great results coming from a tough business are usually indicators of an exceptionally well-managed firm. A good example of such a firm is Uni-Select.

Uni-Select Inc. (current price $10) – doing unremarkable things remarkably well

With a coast-to-coast network of resellers, Uni-Select (UNS) is Canada's second largest distributor of "after-market" auto parts, with 20% of the wholesale market. Operating in a mundane industry, Uni-Select's profitability has been anything but mundane, with after-tax earnings growing by a compound 33.4% since 1990. Even more remarkable, their return on equity has increased from 10.4% to 22%, averaging 18.6% over the past six years, a figure that places UNS among the elite of Canadian corporations. These results are a particularly noteworthy achievement for a company whose industry is growing at only 3-4% per year.

You might wonder if this outstanding record was achieved by aggressive use of leverage, an unsustainably low income tax rate, or creative accounting. The answer is "No" on all counts, since debt has been eliminated over the survey period, and the company has paid full taxes of about 40% every year. Most importantly, UNS has maintained its status as a free cash flow machine, with six-year cumulative cash flow from operations of $55 million exceeding their $6.5 million in capital expenditures by more than eight times. In fact, capital expenditures have exceeded depreciation in only one year since 1990. And, in a test we at Burgundy like to employ when assessing the economic characteristics of a business, UNS's pre-tax return on deployed capital (the sum of net working capital, plus long-term debt and fixed assets) was an exceptional 39% in fiscal 1995.

Having met with and spoken to their CEO, Jacques Landreville, and members of his management team on a number of occasions, we can assure you that their outstanding track record is anything but luck. Take a bow, Uni-Select management and employees, you deserve our applause.

What does Bay Street think of UNS? Not much, apparently. While we would never say that they could not have a down earnings year, the market is currently valuing the stock at just 7.5 times 1995 earnings or half the multiple of the TSE 300 Index. This for a company that, we repeat, is not capital intensive and generates reliable free cash flow. Needless to say, we are shareholders.

The Final Test

We decided on one final screen. We subjected our sample of 27 super-elite companies to the supreme test – the earning and maintaining of a high return on the shareholder's equity. We decided to screen out all companies that failed to earn a return on equity of at least 15% each year for the entire survey period. Imagine our chagrin when the result was known – only four companies made the grade! That's four out of seven hundred twenty eight in the initial sample.

Now there is no doubt that the business climate in Canada over the survey period was awful, with corporate earnings falling to their lowest level since the Depression and a debt-laden, overtaxed and fearful consumer trying to stay afloat, but we would have thought that more than four businesses would have been able to meet our tough challenge. The four that did: Investors Group, Franco-Nevada, Sceptre Investment Counsel and Premier Choix. (Premier Choix had a change of year-end in 1993, but adjusting for a seven-month stub period, they make the grade easily.)

We wish that we could have been the perspicacious investor who bought Premier Choix, Investors Group, Franco-Nevada and Sceptre Investment Counsel at the end of 1989 and held them for six years. Take a look at this:

Six-year Return (Annualized)	
Premier Choix	23.7%
Sceptre	27.5%
Investors Group	22.1%
Franco-Nevada	25.8%
Portfolio Average	**24.8%**

These numbers are approximate, including income for the six years ended December 31, 1995. Obviously, this portfolio would have blown the doors off any major index over that period. Selling them at almost any time would have been a serious error. A $10,000 investment in these stocks would have accumulated to $37,782 at the end of the period. We think that this is convincing proof of the power of the buy-and-hold strategy for great businesses.

Kudos to all of these fine companies. Premier Choix has such a tiny float that we have invested in it through its parent company, Astral Communications. We feel that the capital markets are a little too late in their bull markets to buy Sceptre or Investors now, but we will keep our eye on them, since their results show what a great business money management can be. As for Franco-Nevada, we have the value investor's usual trouble with gold-related investments, especially in the current supercharged environment, but it is definitely on our watch list.

For comparison purposes, we ran the same screens on the U.S. market using our Compustat database. There were 95 companies that had experienced six consecutive years of rising pre-tax earning along with a return on equity of at least 15% in each year. When we raised the return on equity hurdle to 20%, no less than 38 companies made the cut. For a discussion and analysis of these superb U.S. companies, look for an upcoming issue of *The View*.

Author: **Richard Rooney, Senior Vice President and Chief Investment Officer**

June 1996

Berkshire Hathaway's '96 AGM

We attended the Berkshire Hathaway Shareholders' Annual General Meeting held on May 6, 1996 in Omaha. There were a number of subjects of interest that came up during the marathon five-hour question and answer session handled by Chairman Warren Buffett and Vice-Chairman Charlie Munger. We thought several topics, while not new, were quite relevant to the way we run our investment practice at Burgundy, so devoting significant space to Berkshire in this issue of *The View from Burgundy* seemed worthwhile. Like those who are great at most endeavours, Mr. Buffett brings to investing an ability to articulate simple, common sense, easy-to-apply principles that can be very helpful to us lesser mortals.

New Share Issues

A large part of the Q&A session was taken up with Berkshire's issue of Class B shares. Unlike virtually anyone else who has ever done a share issue, Buffett recommended against anyone buying his stock. But when he began to talk about new issues in general, we found his remarks very useful.

Buffett pointed out that there is a tremendous amount of promotion and hype at the time of a new issue. Often, as part of the sales pitch, management states, or certainly implies, that the issue price is "undervalued." Buffett made the point that if management really thinks a new issue is undervalued, then they are harming the existing shareholders by diluting them at a price below what their shares are worth. The management, he said, is doing a great disservice to current shareholders in these circumstances.

New issues are usually not of much interest to us at Burgundy. The reason is simple – they are usually not "bargains." In fact, many of the type of outstanding companies we prefer seldom need to raise equity capital simply because they are sufficiently profitable that growth can be funded from retained profits. Many of our favourite companies are in fact doing share buybacks when circumstances permit. This is currently being done in a significant way by First Empire, Walt Disney Co., American Express and Philip Morris, among others.

In fact, we joke at Burgundy that the true meaning of "IPO" is not the conventional "Initial Public Offering," but rather, "It's Probably Overpriced."

Occasionally, there is an exceptional IPO selling at a good price. Late in 1995, for instance, we took a significant position in a very attractive Canadian insurance company called Kingsway Financial Corp., a niche casualty insurance company with a big market share in non-standard auto insurance. The market was slow to react as it perceived Kingsway to be rather dull. It was obvious no one had taken the time to understand the company's attractive economics and brilliant track record, or to meet its capable management. But all this is to our clients' advantage – they got a good company at a good price and now the stock is up 60% in only four months. We emphasize that an IPO like this is very rare for us. We don't buy stocks expecting this kind of short-term performance.

Capital Inflows and the Timing of Investments

A considerable amount of discussion at the Berkshire meeting centred around the importance of "opportunism" in making investments. Buffett has often made the point that great opportunities come unpredictably and infrequently. Great opportunities are businesses with outstanding economics, run by good people who treat the shareholders as partners in the business, and whose equity is available at a favourable price.

A problem in the investment business is that sometimes investment managers receive money from their clients at inopportune times and feel compelled to invest it. The supply of money becomes the factor motivating the so-called "professionals," rather than the availability of outstanding investment opportunities. This has contributed much of the strength to the recent bull market as people have plunged into mutual funds in record amounts, and many mutual fund managers have in turn been investing this money with little regard for value.

Buffett feels that one of Berkshire's strengths is that he and Charlie Munger are happy to sit with large amounts of cash without it "burning a hole in their pocket." Similarly, Buffett feels that a key factor in Berkshire's success in the reinsurance business is only accepting risks they really want; there is no pressure whatsoever on Berkshire's underwriting team to write policies just to keep busy.

At Burgundy, we see the application of this principle of opportunism as a constant challenge in the conduct of our investment activities. Sometimes money flows in at times when you really don't want it and sometimes there is pressure to invest just to get money working. Even our own analytical staff occasionally feel that if they don't find new opportunities, perhaps they aren't doing their job. There are many other influencing factors, including brokers and the media who constantly promote and publicize their "new ideas" and "stories."

We are very conscious of the principle of opportunism. We try our best only to invest in good companies at good prices. The pressures are very real, however, and while we try to resist them… we may occasionally be influenced by them. Our awareness level is high and we feel that we probably resist better than most, but we must do even better.

An important point to note is that Berkshire has no business plan or budget for its investment activities. There is no pre-ordained plan or blueprint for investment behaviour. Rather, each investment opportunity is evaluated as it evolves, with reference to whether the acquisition is beneficial to shareholders. Similarly, in Berkshire's reinsurance business, there is no business plan with goals for market share, type of risks sought, growth rate or budget.

The Importance of Management

Buffett has always stressed that he devotes a lot of his personal time to the careful study of annual reports for those companies in which he is interested. Wall Street, he says, has not given him a worthwhile idea in 40 years.

One question from a shareholder at this year's meeting was, "What particular information does Buffett look for in reading an annual report?" He stated that on average he spends 45 minutes to an hour on a report. The first thing he looks at is the people running the company:

- Examine management's record; he says that he wants consistent 0.350 ball hitters and doesn't want to gamble on a CEO with weak historical results who is trying to improve his track record. He said that you should avoid the 0.125 hitters who are on a hot streak.
- Try to discern the attitude of the CEO towards the shareholders. Will he treat you like a partner?
- Look for managers who know and love their business, and respect their shareholders.

Reporting to shareholders should outline the material things that have happened over the last year and what the future risks are. Reporting to shareholders should be the same as reporting to a 50% partner in a private business who has been out of the country for a year. Buffett has also talked about how important it is that management should want shareholders to understand what they are doing. If you have difficulty understanding an annual report, it's probably not an accident.

Management should run their companies as if they were going to be running them forever. In other words, deal with the problems now, plan to grow over the long term and don't worry about looking good over a one-year period. A really great company is not only great for three years but for a lifetime.

Buffett says that businesses with poor economics won't survive at all in the long run unless they have good management. Really great companies with strong economics don't necessarily require such great management, but when you find great management and a great business combined, "Bet heavily and don't sell out," [32] he said.

This is an area of weakness in the investment management industry in our view. When dealing with vast quantities of money in this complex world, institutional investors often rely heavily on statistics, computer screens and brokerage reports. The assessment of management and the structure of the Board of Directors and their capabilities receive only limited scrutiny, although to us it seems enormously important.

The assessment of management is an area of focus at Burgundy. It's an area where mistakes can be easily made, and assessing people is never easy. But in publicly traded companies, the diligent investor is greatly assisted because of the availability of plentiful information including historical financial data, speeches by the CEO, annual reports and annual meetings.

If you want your management to think like shareholders, Buffett advocates making them shareholders, not through fixed-price stock options but by way of actual cash purchases. Ten-year fixed-price options are essentially interest-free loans. You wouldn't do it as part of your regular business so you shouldn't do it just to increase share ownership.

Concentration of Investments Versus Diversification

Buffett is a tremendous believer in concentrating his money in relatively few well-chosen businesses or stocks. Buffett says, "All you need in your lifetime are three great businesses and you can get very wealthy." [33] How many great fortunes have come out of portfolios with 40 or more stocks in them? The main advantage to diversification in investments, he said, is "protection against ignorance." [34] The conventional institutional investor's practice of widespread diversification is a confession to not really understanding the individual business that well. For example, "There simply are not very many companies with economics as outstanding as Coca Cola," [35] he said.

A discussion of diversification in investments led to wide-ranging comments on the subject of corporate finance and investments as taught in business schools, and presumably (although not stated) in the Chartered Financial Analyst (CFA) program.

Among the topics emphasized in such courses are "diversification" and "the efficient market theory." The efficient market theory holds that it is impossible to "beat the market" in the long run. At the mention of these subjects, the normally reticent Charlie Munger came to life with a vengeance. "Much of what is taught in modern corporate finance classes is twaddle," [36] stated Munger emphatically.

The Securities Industry

In reference to Salomon Bros., Buffett talked about the relative "value of the chair versus the value of the trader" [37] and asked this question: "Would you rather own a piece of the Mayo Clinic or its best surgeon?" [38] In the end, the surgeon may feel that he is responsible for all of the success, and will want all of the reward. But the Mayo Clinic's reputation rests with no one individual, but rather with the institution. Wall Street has a problem with dividing up credit and profits between shareholders and insiders. While some securities firms manage this issue better than others, it remains the highest concern for investing in brokerage stocks.

In terms of volatility of earnings, Buffett thought that this was the nature of the securities industry. Volatility is fine as long as the company achieves a high average ROE over time. In his Annual Report for 1995, he said that he "would rather own a company with lumpy earnings and a 15% average return on equity (ROE) than a company that earned 12% every year." [39]

Buffett's Comments on Specific Companies

Freddie Mac/Fannie Mae:

> The business is riskier than in the past due to the nature of contracts. Mortgage holders can pay back the mortgage without penalty or keep it for 30 years – a very disadvantageous relationship when you are the holder of the mortgage. Freddie has offset the risk somewhat through the use of callable debt and further structuring of its balance sheet, but it remains a more difficult business than it once was.

First Empire:

> In banking, as in any retail, anything you do can be easily copied, though there is some advantage in being first. If run right, banks can be great businesses, and Bob Wilmers runs First Empire right.

Walt Disney Co.:

> Buffett said that Michael Eisner is an example of a great manager; the business is getting more competitive, especially in animation, but Disney has

a better chance of maintaining a special place in the minds of children and adults in the future.

Walt Disney Co. owns a number of wonderful assets, such as Snow White and Mickey Mouse, for which they pay nothing to use again and again. To Buffett, the great thing about Mickey Mouse is that he doesn't have an agent.

Owning the rights to a movie like "Snow White" is like having an oil field where you pump out all the oil, sell it, and then the oil seeps back into the field to be pumped out again.[40]

Author: **Tony Arrell, Chairman and Chief Executive Officer**

September 1996

Second Class Owners

By the end of 1996, The View from Burgundy *was getting noticed. One of the most ambitious issues of the newsletter that we ever wrote concerned dual class share structures (DCSS), where a small class of super-voting shares controls a company, while the vast majority of public shareholders are effectively disenfranchised. We were interested in this phenomenon where it affected us most – in equity performance in the public markets. We did a vast amount of number crunching in order to get performance data on Canadian companies with and without these share structures for several years prior to 1996. We found a tendency for companies with DCSS to underperform, and gave our opinion on the potential for governance issues arising with these structures.*

Interestingly, there does not appear to have been a definitive academic study of the phenomenon, and as recently as 2005, this issue of The View *was quoted in the financial press.*

Richard Rooney, 2007

Preamble

After our analysis of the relationship between reliably rising earnings and stock market performance in the "Capital Punishment Part II" issue, our researchers at Burgundy got really ambitious and decided to tackle a subject that has long interested us, namely the issuance of subordinated voting and non-voting shares and their impact on performance. This is a big, complex subject, so we decided to approach it systematically.

Let's declare our biases right off the bat. We believe that while subordinated voting and non-voting shares are a form of ownership, they are not equity in the true sense. They entrench management and may permit arbitrary decision-making. By definition, they are undemocratic. We are inclined to oppose them as an abuse of corporate governance.

The reasoning behind our opposition is simple. There is no better incentive to economic efficiency for a publicly traded corporation than a free market in the company's common equity. As the economic history of the past 20 years has shown, underperforming companies whose management is not entrenched by control blocks or multiple voting stock are routinely bought up and made efficient by new management and ownership groups. The process is often nasty, and sometimes greed, speculation and incompetence can cause tragedy, as in the case of Canada's own Robert Campeau, but it is beneficial to the economy and shareholders in the long term. Subordinated voting and non-voting arrangements block this process, enable underperforming managements to remain in control, and may contribute to sluggish economic performance.

Subordinated voting shares are rife in Canada. We decided as a first step to find out how widespread they are, and in what industries they are most likely to occur. We would then attempt to assess whether they have had an adverse effect on stock price performance.

Methodology

We should point out that our testing and sampling, while laborious and detailed, does not involve the level of precision required by academic analysis, for example. We are using large enough samples that the aggregate numbers should be accurate. But we are not doing sufficient testing to draw ironclad conclusions. As practitioners rather than pure researchers, we are trying to be approximately right rather than exactly wrong. We believe our survey will meet that standard.

The Stock Guide database accumulates the last eight years of data for the companies it contains, so the universe we used in our study was all Canadian equities on the Stock Guide database, which were public from December 31, 1987 to December 31, 1995. They totalled 413 companies. Of those, 121, or 29.2% of the total, had dual class share structures (DCSSs) and 292, or 70.8%, had single class share structures (SCSSs).

Relationship with Company Size

By market capitalization, the DCSS companies tended to be smaller, with an average market cap of $534.4 million, and a median market cap of $109.9 million, versus an average market cap of $1.24 billion and a median of $171.2 million for SCSS companies. That is not surprising since a lot of Canada's largest companies, like CP Ltd., Seagram, the chartered banks and the major utilities do not have DCSSs. In the case of the chartered banks and some utilities, they have legislative protection from takeovers, which is even more effective than DCSSs as a method of management entrenchment.

Industry Concentration

The industries where DCSSs were most likely to occur were communications and media, where 17 of the 26 public vehicles had them, followed by transportation (4 out of 7), conglomerates (3 out of 6), merchandising (9 out of 22), consumer products (16 out of 43), industrial products (20 out of 69) and financial services (13 out of 45). Generally, the resource/cyclical sectors had very low levels of DCSS incidence.

Why this concentration in the consumer end of the Canadian economy? We can think of a couple of reasons. First, the Canadian government has traditionally protected the Canadian consumer from the overwhelming influence of the American market. In some cases, this resulted in the diversion of profits earned from American products into the pockets of favoured local interests.

Take these three examples:

- Until recently, in areas like broadcasting, a small number of companies were licensed by the government to import American programs and sell them for oligopoly profits in the Canadian market.
- The old system of tariffs and duties allowed Canadian retailers to charge higher prices to Canadian consumers until the free trade agreement changed the buying habits of Canadian shoppers (remember the cross-border shopping mania of 1990-1993?).
- Canadian breweries were protected by requirements for in-province brewing and industry control of distribution channels.

The point is that if you owned a TV station or a retail chain or a brewery, it could be a licence to print money. If you went public in order to acquire other TV stations or breweries, it was a good idea to protect control through a DCSS. Ironically, this has meant that DCSS companies tend to cluster in groups of good, cash-generating businesses, which investors like Burgundy love to own.

Another reason for the consumer concentration is that these are often the kind of businesses that an entrepreneur with a good idea can start up. The problem is that entrepreneurs with deep pockets are a bit of a contradiction in terms. Once they have established a growing, prosperous business, they must find a way to maintain control while tapping the capital markets to fuel growth. DCSSs solve this problem.

And they have been used successfully by some great business leaders. Ted Rogers, George Gardiner, Frank Stronach and Prem Watsa have all created enormous amounts of shareholder wealth using DCSSs to protect their control. It is an interesting question whether Magna's Board of Directors would have left Frank Stronach as CEO in the dark days of 1990-1991 if he had not controlled the company. And if they had removed him, would Magna have made its comeback, perhaps the greatest in Canadian business history?

Obviously, there are no easy answers in this area.

Impact on Share Prices

So what is the performance impact of DCSSs on stocks? We measured the total return on all 121 companies having dual classes over the eight-year period ending December 31, 1995 and then took a simple unweighted average of the compound returns. We then compared the results to the total average compound return of all companies with SCSSs for the same period. Here are the results:

ANNUALIZED COMPOUND RETURN December 31,1987 - December 31, 1995	
Single Class Share Structures	2.5%
Dual Class Share Structures	1.8%
TSE 300 Index	8.5%

So on the face of it, it looks like our case is proven: DCSSs underperform. But that was a little too simple. The fact is that our time period starts in 1987, and we seem to recall a little volatility late in the year. Also, Canadian consumer stocks had done exceptionally well in the early 1980s and we were wary of statistical anomalies caused by end-date sensitivity.

With this in mind, we re-ran the numbers for the five-year period ended December 31, 1995. The result was the following:

ANNUALIZED COMPOUND RETURN December 31,1990 - December 31, 1995	
Single Class Share Structures	8.6%
Dual Class Share Structures	8.1%
TSE 300 Index	10.8%

Again, DCSSs appeared to be disadvantageous relative to SCSSs. It is interesting that the difference is about the same: 0.5% vs. 0.7%. Two sets of observations are obviously insufficient to draw a conclusion, but there appears to be some support for the thesis that DCSSs underperform SCSSs in the stock market. We believe that there has been some research in the U.S. that also tends to support this view. We should point out that these differences are not immaterial. (Just ask any money manager who underperformed a benchmark by 0.7% over eight years – if you can find one still in business.)

A Digression

"Random walk" proponents (those who think throwing a dart at the stock page is as likely to pick a winner as painstaking research) may be surprised at the enormous difference in returns between the average compound returns for our sample, and the returns on the TSE 300. There are two reasons for this. First, the TSE 300 benefits in a big way from "survivor bias." Survivor bias means that losers are thrown out of the sample so that there is a favourable bias to the returns. As anyone who has followed the TSE 300 for a long time knows, the Index is very unstable and changes radically over time. (Remember when Dome Petroleum was 7% of the TSE 300 Index?) Secondly, the TSE 300 is a capitalization-weighted portfolio and is driven by changes in relative weightings. Our sample, by contrast, is an unweighted average of all stocks public for the whole eight-year period from 1987 to 1995, so it represents the probable return of a random choice from this list of stocks. Throwing a dart at our sample would not have been a particularly rewarding experience, since 53 out of 121 stocks with DCSSs had negative returns over this period, as well as 117 out of 292 SCSS companies. That's right – a shocking 41% of the companies in the sample delivered negative returns over the eight-year period. We think we'd rather do the research.

Another point to remember is that the sample we arrived at is also tainted by another specific type of "survivor bias." There have been many takeovers in the Canadian market in the past eight years, and of course none of the acquired companies are in the sample. Given that the main reason for DCSSs is to prevent takeovers, it is probably a safe assumption that the vast majority of takeovers have been of companies with SCSSs. Thus, the excess returns generated by takeovers, which may have disproportionately benefited shareholders of SCSS companies, are not included in these return calculations.

Dilution Danger

We thought one reason that might account for the underperformance of DCSSs relative to SCSSs was the possibility that an entrenched management might consider its subordinated stock to be "just paper" and issue massive quantities of it, thus diluting that class of shareholder. We therefore screened to find out whether there was a greater propensity to issue stock if a DCSS was in place.

On the contrary, we found that over our eight-year test period, the 121 companies with DCSSs in place issued, on average, 92% of their original capitalization in new stock. The 292 companies with SCSSs issued 120%. We thought that we could eliminate a distortion by taking out the oil and gas sector, which, as a huge ongoing issuer of new equity, is the best friend of the Canadian corporate finance industry. After we removed them from the sample, the DCSSs had issued only 49% net new equity over the survey period, while SCSSs had issued 100%.

So, companies with DCSSs in place were not necessarily prodigal issuers of shares, or at least were less prodigal than companies with SCSSs. We were startled by the tendency of Canadian companies to issue equity, but could not say that DCSSs were a determining factor.

As we have pointed out on a number of occasions in prior issues of *The View*, companies that habitually issue equity are often below-par performers, and investors are wise to look for companies that either are buying back stock or at least issuing it sparingly.

Conclusions

So what conclusions can we draw from our work? We think that there are several.

- The stocks of companies having DCSSs tend to underperform those of companies with SCSSs. The performance differential is small, but not insignificant.
- The performance differential may be understated because it excludes takeovers that took place during the sample period.
- The underperformance may result from concentration of DCSSs in certain industries and in smaller capitalization ranges, both of which may have underperformed in the sample period.
- There does not appear to be any greater propensity to issue stock under DCSSs than under SCSSs, which we found surprising.

Unfortunately, DCSSs are not the only barrier to a free market in equities in Canada. Aside from control blocks in companies like Seagram, Weston, Imperial Oil and Imasco, which are simple majorities of single class voting shares, there are legislative barriers to takeovers of banks, utilities, airlines and former Crown corporations. In the case of communications stocks, there is not only legislative protection under Canadian ownership rules, but also a plethora of DCSSs to entrench management, thus adding insult to injury.

And as we pointed out earlier, some people who have gone public using multiple voting stock to retain control have generated a lot of shareholder value. Izzy Asper, Jim and Les Shaw, Laurent Beaudoin – all have been big contributors to such success as the Canadian stock market has had. No investor, least of all Burgundy, should wish to stunt such careers as these. The problems seem to arise once the major entrepreneur leaves the scene. So in the interest of reasonable compromise, we suggest the following measures be taken by Canada's securities regulators:

- Non-voting stock is an abomination and should not be permitted to exist.
- Multiple voting stock should not be allowed more than 10 votes per share.

- All such stocks should have a sunset clause requiring a free vote on renewal of the dual class shares every 10 years or upon the death or retirement of the CEO.
- On a takeover bid, all shares should be treated equally.

While our research into this topic didn't yield the hard conclusions we had wanted, there was an abundance of interesting insights and avenues for further work. We will share these with our readers in upcoming issues of *The View*.

Author: **Richard Rooney, Senior Vice President and Chief Investment Officer**

December 1996

The Crying Game

During 1996, a new kind of investment product had appeared on the Canadian scene. The royalty trust or income trust started in the resource area and spread to virtually all other sectors of the Canadian market over the succeeding decade. Our first quixotic attack on aspects of this new type of security was in this issue. We were particularly concerned with oil and gas royalty trusts. However, careful reading of this article, and of all succeeding Burgundy articles about income trusts, shows that Burgundy never opposed them root and branch. We felt that for a certain kind of business they were a great idea, and still do. But as usual on Bay Street, a good idea was taken to ridiculous lengths and the government had to shut them down.

We must point out, however, that by and large these assets performed very well for most of the 1996 to 2006 period, due to an unusual combination of strong commodity prices and declining interest rates, so our forecasts of extreme disarray in the income trust markets were never borne out.

Richard Rooney, 2007

Readers of *The View from Burgundy* are aware that capital allocation is one of the issues we constantly refer back to in our analysis of companies. The one thing above all others that is guaranteed to infuriate us is a company that possesses or generates substantial cash in excess of its normal operating requirements, lacks high return investment opportunities and refuses to pay out this money to shareholders. We have mentioned several examples of this "hoarding instinct" among the managements of Canadian businesses, such as Imasco, Canadian Marconi and Moore Corporation. In the last year, a new product has appeared on the Canadian investment scene that involves the complete payout of cash flows in excess of operating requirements from assets in a wide variety of Canadian industries. That product is called the royalty trust.

It would be logical to expect us to like royalty trusts, since by definition they prevent managements from squirreling away cash that rightfully belongs to the shareholders. And, in theory, we do. In the case of a no-growth business that generates a reliable stream of free cash flow over a very long time, we think that they are a brilliant idea. Unfortunately, in the overheated investment atmosphere of 1996, brilliant financial ideas are often extended into realms where angels fear to tread. With staid and sober Canadian fixed-income investors starving for yield, they have embraced royalty trusts with great fervor and a complete lack of discrimination. Indiscriminate embraces often lead to unpleasant after effects! We suspect that this is as true in investing as in life, and will in time bring pain to investors in some of the royalty trusts we see being issued today.

The problem is that royalty trusts have been seized upon by the most capital-hungry business in Canada as an avenue for cheap financings. We refer, of course, to the oil and gas industry.

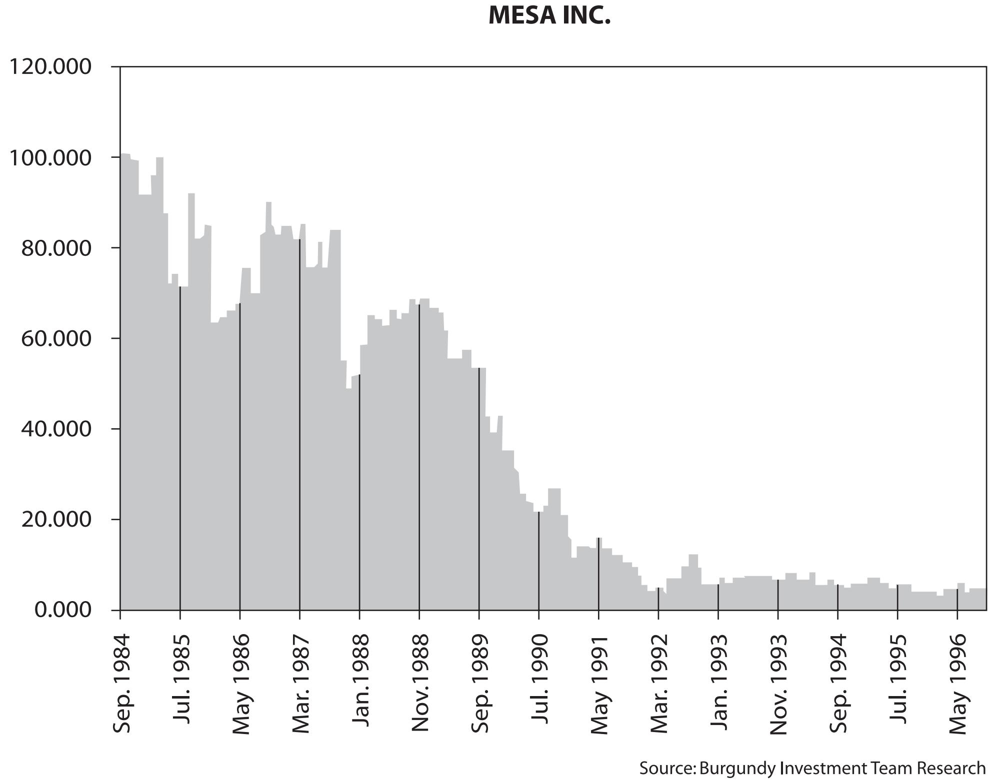
A Cautionary Example

An oil or gas well might on first sight be considered to be an ideal prospect for a royalty trust, since it is an asset that produces cash flow year in and year out for a long time.

Boone Pickens, the flamboyant corporate raider of the 1980s, thought so when he turned Mesa Petroleum into a type of royalty trust called a Master Limited Partnership (MLP) in 1985. The idea was exactly the same as that of our Canadian royalty trusts, with some differences in the legal structure of the final product. All cash flows beyond the operating expenses of the company were to be paid out, and the company was to acquire new long-life reserves as it went along. The market, which considered Mr. Pickens a genius at that time, applauded loudly, sending the price of the MLP units to $100 the same year. Large distributions were made in each of 1986, 1987, 1988 and 1989. The Master Limited Partnership made several large acquisitions and the balance sheet became rather leveraged. The 1990 distribution was only $1.875 per share, which did not support a unit price that by that time had fallen to $30. In 1991, the MLP units were reconverted to corporate form at $10 and no distribution was made; after several refinancings, all grossly dilutive to the original shareholders/unitholders, they trade today at $5.

Even after giving credit for distributions amounting to $39 over the period 1985-1989, the Mesa MLP units must be considered a failure as an investment, since only those who paid $49 or less even received their money back on a simple payback basis at the time of the reorganization; the price paid would have had to be far lower for investors to have earned a reasonable rate of return over that period. We append the stock price chart of

Mesa from late 1984 to the present day. The six years from 1985 to 1991 were the period during which it resembled a royalty trust.



A Roulette Mortgage

Those who paid $100 in 1985 for a notional "yield" of 7.75% on their Mesa MLP units were obviously gravely disappointed. This yield illusion is the driving folly behind the great royalty trust bubble of 1996. Much is made of the fact that distributions from the royalty trusts are "tax advantaged," since Revenue Canada treats most of the distribution as a return of capital. Now there are two ways to look at this information. First, Revenue Canada is totally wrong about the tax treatment and is missing out on a great opportunity to tax a type of income to Canadians. In this case, given its past form, Revenue Canada will act with dispatch to remove this advantage and tax the income as dividends or as interest, whichever it deems appropriate. In other words, if Revenue Canada is wrong, the holder of royalty trust units is one tax ruling away from taxable status.

The second possibility is that Revenue Canada is right in its economic assessment of royalty trusts and that a huge portion of the distribution received is return of capital, or if you like, repayment of principal. In this case, what you have is a "roulette mortgage" on which you know neither the term nor the interest rate. Would you lend your hard-earned dollars in this form? We doubt it. What might be the result of buying a royalty trust if Revenue Canada is correct? Fortunately, someone has done the numbers.

The royalty trusts have been a bonanza to the corporate finance industry. One highly respected securities firm in Calgary has been particularly cautious about the "gold rush" because it believes that many of the royalty trusts will turn out badly. That firm, Peters and Co. Limited, has turned its back on a lot of quick cash in the interests of the investing public, which is not normal behaviour in the financial industry during a bull market. We cannot speak highly enough about this firm and its decision to sacrifice very attractive short-term returns to maintain its long-term reputation. The firm's president, Michael Tims, gave a provocative and interesting speech to the Canadian Energy Research Institute in September 1996, in which he examined the royalty trust phenomenon. Let's look at what he had to say.

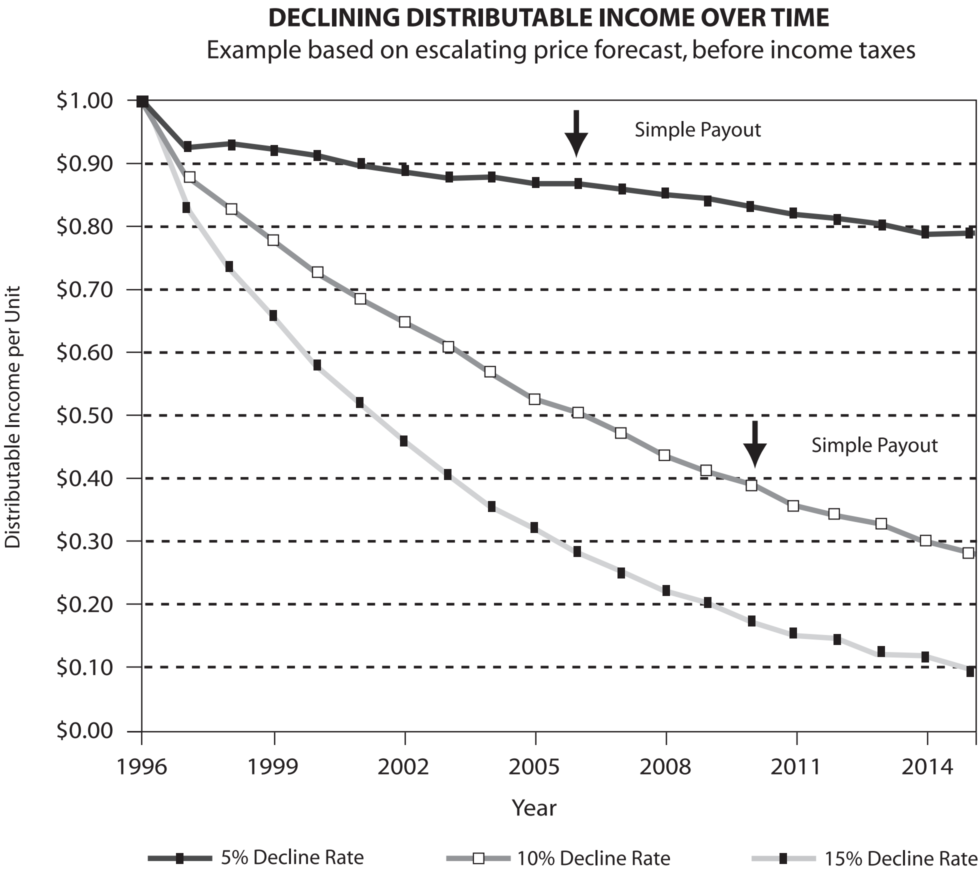
Mr. Tims looked to the U.S. experience in Master Limited Partnerships to see where they had gone wrong. He found six main factors that made these products a disaster. These were:

1. Overpaying for assets
2. Unanticipated commodity price declines
3. Excessive fees paid to investment bankers, management companies, resource companies, consultants, etc.
4. Poor reinvestment of cash flows into existing assets or new assets
5. Excessive leverage, which became critical as the revenue stream declined
6. Income tax law changes

While Mr. Tims believes that we have learned something from the MLP boondoggle, he presents a list of potential problems that give us pause. The three points that we would like to examine concern the decline rate on distributions from royalty trusts, the impact of commodity price assumptions on returns, and the impact of taxes on returns. (As an aside, Mr. Tims had a list of no less than 11 factors to watch in buying royalty trusts, which indicates to us the complexity and potential for misunderstanding inherent in this product.)

First, we look at the impact of declining distributable income resulting from simple production declines, a permanent and inevitable feature of oil and gas properties where declines begin from the day production starts. Our example assumes that the cash distributions decline in line with production from the underlying wells.

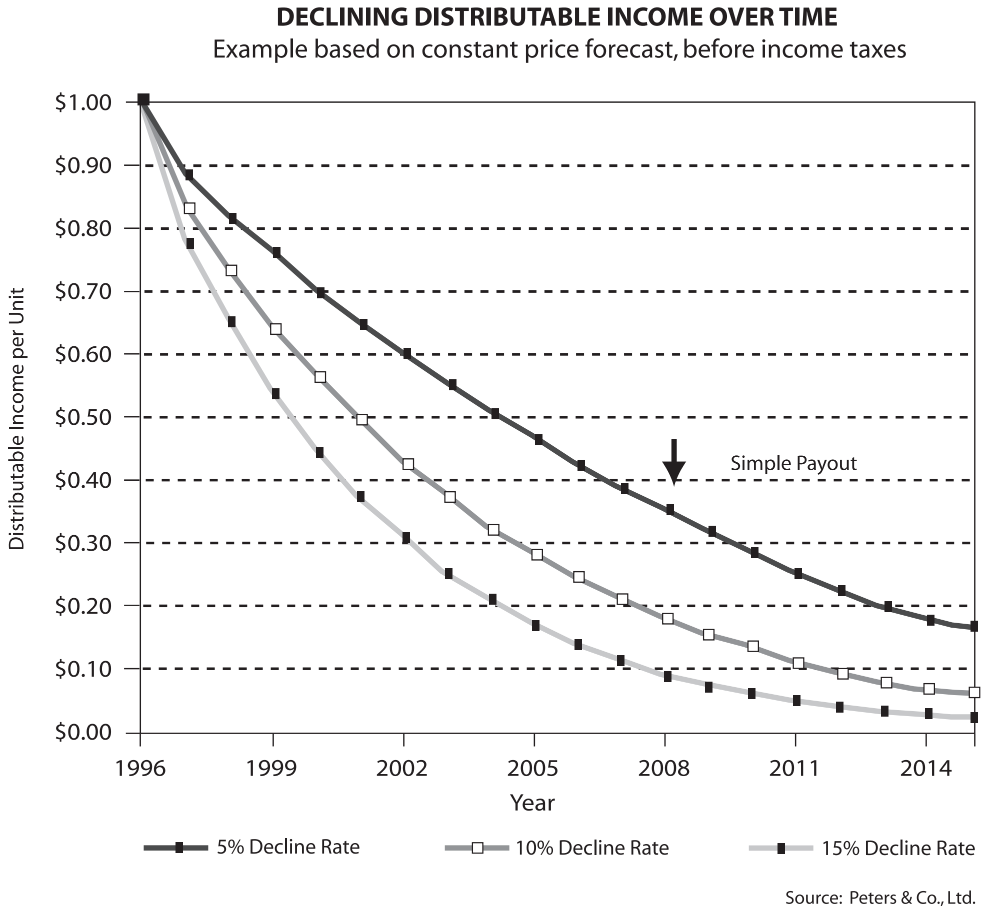
The chart assumes three decline rates: 5%, 10% and 15% annually. The chart also assumes steadily rising prices for the commodity underlying the trust, usually at a rate of 2 – 3% annually. No taxes are assumed to be paid.



Source: Peters & Co., Ltd.

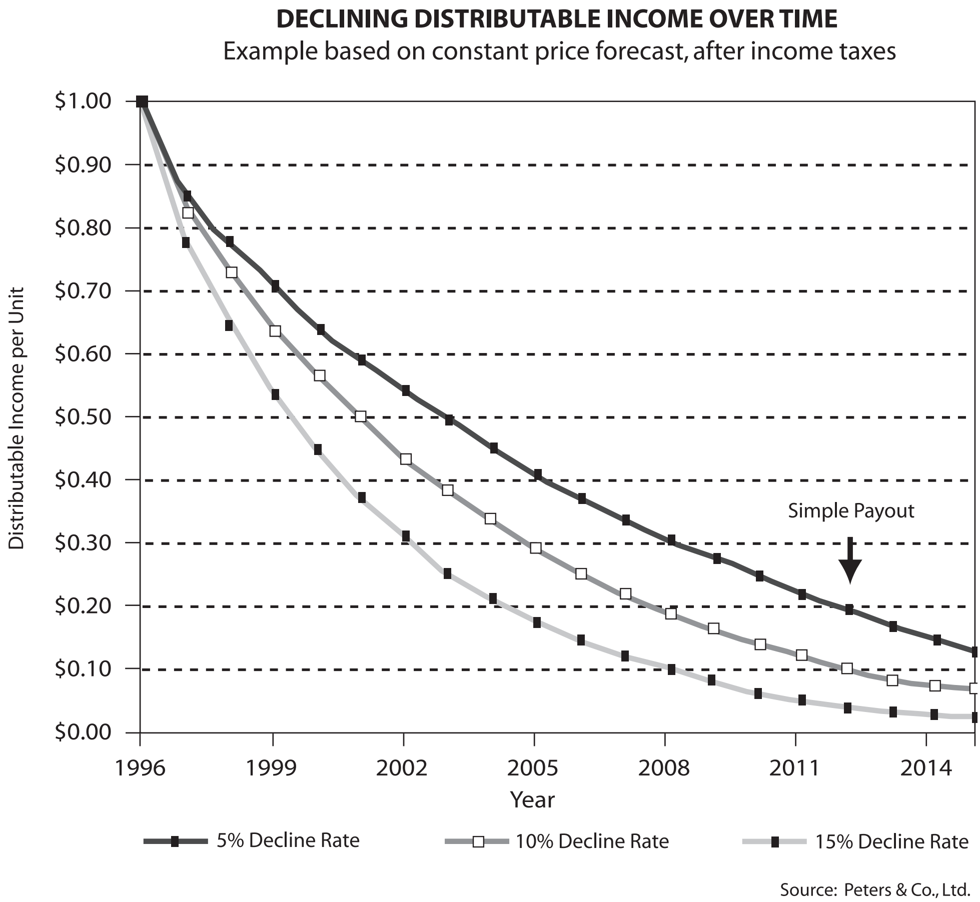
As you can see, at a 5% rate of decline, the investor receives his money back, undiscounted, in 10 years, or 2006. At a 10% rate, the payback year is 2010, while a 15% annual decline will not payback until after 2015.

But we all know that commodity prices do not rise at nice steady rates. The oil price has in fact been pretty flat for the past 10 years, and is now at the high end of the trading range over that period. If we use a flat price forecast to examine the returns, we get the following chart:



With constant commodity pricing, simple payout occurs in 2008 for a trust with a 5% annual decline rate in distributions. Neither the 10% nor the 15% decline rates payout before 2015; that is to say, there is nothing earned on investment for at least 19 years.

And since these products are very much being sold on their tax advantaged status, we must of course incorporate the effects of income taxes. Then, if we make some taxation assumptions on our constant price model, we get the following chart:



At a 5% rate of decline for distributions, after-tax payout occurs in 2012, while neither the 10% nor the 15% decline rates payout before 2015. We are long-term investors at Burgundy, but these time frames are a little too long for us. We would like to get our returns in the future, not the hereafter.

So are all royalty trusts bad? Of course not. At our firm, we have bought shares in one of them, the Athabasca Oil Sands Trust. The Trust in question owns 11% of Syncrude, the huge project near Fort McMurray, Alberta. The oil sands are the definition of long-life reserves, since there is about as much oil there as in the whole Middle East. Cash flows are very reliable (though in the event of high capital expenditures and low oil prices, the payout on the trust units could be interrupted at any time) and production costs have shown a downward trend over time. It seems reasonable to assume that the oil sands will be a good source of cash flow for a very long time, and that the eventual return on investment may be 10%, given conservative assumptions.

Westar

In fact, there are probably a lot of assets in Canada, many of them non-resource assets, which could be better investments if they were placed in a royalty trust. A striking recent example was provided by Westar, a stock in which Burgundy holds a large position.

The Westar example shows why it is such a good idea to invest in good businesses run by good people. Westar is the remains of the old BC Resources Investment Corporation, or BCRIC. This relic of the 1970s interventionist government in British Columbia was living proof that if you wanted to find something worse to invest in than an ordinary conglomerate, have a government construct a conglomerate for you. Built up with resource assets purchased at the peak of the inflationary boom, BCRIC lost almost a billion dollars and sold off assets at fire-sale prices through the 1980s until, by 1993, it had no assets left but huge loss carry-forwards for tax purposes, almost $200 million in capital losses for tax purposes, and the Roberts Bank Coal Terminal in Tsawassen, south of Vancouver. The company had huge debt levels and was, for all intents and purposes, bankrupt.

At that point, one of Canada's best businessmen appeared on the scene. Jim Pattison is legendary in British Columbia, but less well known outside it. He has built a very large (and very private) empire embracing car dealerships, food retailers, packaging companies and a variety of service firms on the Lower Mainland of B.C. Very little happens in that part of the world without Mr. Pattison being aware of it. And at a time when Westar was a joke or a swear word to most people who knew anything about it at all, Jim Pattison and his right-hand man, Nick Geer, saw an opportunity.

Consider the Roberts Bank facility. It is an unsightly thing, jutting miles out from shore off one of the world's most beautiful coasts. It takes almost all the coal from the rich Southeast B.C. coal mines, which then must be exported to Asia. Huge volumes of coal – at least 15 million tonnes – pass through the facility every year. And on each and every tonne, the Westar terminal collects $5.50. It is quite unlikely that anything like another Roberts Bank coal terminal will ever be built on the west coast of North America, given the environmental sensitivities in that part of the world. We hasten to add that the negative environmental effects of the coal terminal are purely aesthetic; coal is a very inert substance, so there is little pollution of air or water associated with the terminal.

At Burgundy, we like to invest in businesses that we understand, and which produce reliable cash flows for shareholders. We think that Westar is one of those businesses. It is a toll booth, and owning a toll booth is a very attractive proposition, especially when no one else can set up another one nearby.

Mr. Pattison thought so too. In a masterly series of transactions, he gained economic control of Westar, and cleaned up its balance sheet. In the last week of October, he announced that he was considering spinning the Roberts Bank terminal into a royalty trust. At the time of the announcement, Westar had a market capitalization of $250 million. With $50 million in annual cash flow, capitalized at 10%, the assets would potentially be worth $500 million in a royalty trust. We might argue that given the virtually perpetual nature of the cash flows through the terminal, a lower capitalization rate might be appropriate, and therefore a higher price. But you get the idea – with one announcement, Mr. Pattison doubled the potential value of his (and our) Westar investment. (We hasten to add that we have not yet seen a prospectus for the proposed trust and our numbers are estimates only.)

This is not to say that the Westar royalty trust will be without risk. There will be two main risks: the risk that volumes of coal through Roberts Bank will fall (a certainty since coal demand is cyclical and is currently very strong); and the risk that the price per tonne of coal that Roberts Bank can charge the industry will be reduced from the current $5.50 per tonne. Either of these events could cut the cash flow from Roberts Bank in half in any given year. A combination of the two could make the royalty trust eliminate its distribution entirely. And we are obliged to note that the smarts here are definitely possessed by Messrs. Pattison and Geer, and they are selling, not buying, royalty trust units. The same could be said of most royalty trusts: they have some of the characteristics of an insider sale.

Conclusion

Clearly, royalty trusts can have a useful role in Canadian finance, and some of them can provide high quality yield on an after-tax basis. Westar may prove to be a good example. But royalty trusts, based upon wasting assets and declining revenue streams from commodities with volatile prices, could prove to be a recipe for disaster. Not only that, the clientele being attracted into the royalty trusts tends to be retired savers who are trying to increase yield in an era of very low nominal interest rates. Many have never invested in anything but fixed-income guaranteed products. This mismatch of client and product bodes ill for the future. We think that many of the royalty trusts that Canada's underwriting firms are launching and placing in client accounts will prove disappointing, and some will end in tears. In the invariable custom of the capital markets, it will not be the underwriters who are weeping.

Author: **Richard Rooney, Senior Vice President and Chief Investment Officer**

February 1997

Performance Killers

The 1990s have been among the best years in history for investors in the capital markets. Yet we know many intelligent people with money to invest who have done much worse than they should have, in a period when great returns were there for the taking. There are many reasons for poor investment results. We believe that some basic behavioural traits cause the most common mistakes. In this issue of *The View from Burgundy*, we will share experiences and observations on this subject, so that perhaps we can help some people become more successful investors. Here are some of the "performance killers" we have witnessed:

Fear of Opportunity and Misjudgment of Risk

Traditional economics teaches us that when prices for goods are low, demand is stimulated, but that as prices rise, demand declines. This is the concept of demand elasticity and every former economics student knows how to graph the relevant curves. If you offer a "bargain," be it for winter coats or sirloin steaks, the lower prices will normally attract more buyers.

Oddly, it seems that in the investment world the opposite is true. High prices attract more investors. As prices of individual securities or mutual funds rise in a bull market, more people become buyers, which bids up prices even further. And as stock prices rise, the executives of public companies, and their handmaidens, the large securities firms, create new issues for the investor to buy. Eventually supply exceeds demand and prices decline.

Benjamin Graham, the father of value investing, wrote a classic article for *Ladies Home Journal* in the 1940s in which he (having despaired of inculcating sensible investment habits in the nation's men) addressed the following brilliant exhortation to America's women: "Ladies, buy stocks the way you buy your groceries, not the way you buy your perfume."[41] There exists no better quick summation of the value investor's approach. Hard-headed calculation and a focus on price and that elusive thing called value is the basis of this method. Most of us can recognize value when we see it at a supermarket or at a hardware store. We have a little more trouble in a jewelry store or in a perfume boutique, where considerations of status, emotion and perception come into play. Value investors believe that any sensible person can behave the same in the stock market as in a supermarket. If a good stock is "on sale" in the stock market, it should be bought, period.

But, just as high prices seem to attract investors, so too do low prices seem to scare them off. We believe that the best way to make money is to own outstanding companies run by capable management, which can be trusted to act in the interests of shareholders. But everything in the market has its price, and the long-term returns from even the best investments are heavily influenced by the price you pay for them. Someone recently calculated that if you had bought the "Nifty Fifty" stocks of 1972 at their very highest prices (and they were VERY overpriced) and held them until today, you would have outperformed the S&P 500 Index. That person's point was that you should be able to buy good stocks anytime and that you will eventually do well; this is, theoretically, a good point. In practice, however, waiting 20 years for your investments to come onside is something few investors have the patience or the resources to do. On the other side of the ledger, if you had bought the "Nifty Fifty" stocks in 1975, when they were bombed out and deeply unpopular, you would have returns like Warren Buffett. That's basically what he did. So, the difference between the patient investor and a Hall-of-Famer like Buffett is in large part the price at which stocks are bought.

Market Timing, Pessimism and Bearishness

In the last three years, probably the largest single performance killer has been market timing. Some people confuse opportunism with market timing, but they are entirely different things. Opportunism is focused on individual businesses and stocks, while market timing is based on general sentiments about "the market." Opportunism is based on optimism – it looks for a break in a company's stock price but maintains a belief in the attractive nature of the company's business. Market timing is based on a pessimistic assessment of market valuations, economic forecasts or political risks. Not surprisingly, specific optimism beats generalized pessimism most of the time. After all, if someone doesn't want to invest in good markets, what are the chances they will act in bad ones?

Bearishness has its attractions. There is something in human nature that finds it deeply rewarding to look on the dark side, and certainly the stock market – with its extravagant tales of cupidity, sleaze and stupidity – is a fine theatre of the absurd for the cynical and the skeptical. And, of course, while bulls make most of the money, bears have most of the good lines. At Burgundy, we think that Jim Grant – publisher of *Grant's Interest Rate Observer* – offers the best and most consistent financial writing. Grant's general bearishness is expressed in a writing style so fluent and shot with humour that he has kept the honest esteem of investment professionals, despite being consistently far too early in his projections of loss and gloom. Indeed, one of the small, but meaningful consolations of the next bear market will be to attend the Grant's conference in New York City and to applaud Jim for his acutely perceptive foresight. Nonetheless, we are reminded of what Warren Buffett calls the Noah principle: "Predicting rain doesn't count, building arks does." [42] Everybody knows markets will go down; the problem is to do something sensible about it with your money.

The great investors and moneymakers throughout history have been optimists. Warren Buffett's ease and grace are based on a fundamentally happy view of the world. Listening to John Templeton enthuse about the excitement and opportunities of our times is a good antidote to depression. Even Ben Graham, who is often taken as a patron saint by the bears, was an optimist who found a way to make money in the toughest equity markets in history. Phil Fisher, Peter Lynch, all these great investors were – despite their very different approaches – fundamentally people who felt they were surrounded with opportunities to be seized, not risks to be avoided.

Just as you study Bach to learn music and Einstein to learn physics, we feel that you should look to these great investors to learn about investing. An optimistic attitude, desire for a margin of safety and a focus on specific opportunities is what we believe must be fostered by would-be investors. As Buffett says: "The most common cause of low prices is pessimism... we want to do business in such an environment, not because we like pessimism but because we like the prices it produces." [43] Too many market timers simply like pessimism.

Not Doing Enough Homework

It is amazing how little work and thought most people put into their investments. For some reason, the stock market induces a type of behaviour in people that is seen nowhere else in their economic lives. They act largely on impulse and rely to a large extent on specific advice from so-called "experts" in stock market matters.

Think about the big-ticket purchases most people make in their lives. There are certain minimum levels of investigation undertaken by almost everyone, which guarantee a degree of satisfaction with those purchases. In the case of a house purchase, people have an idea of the type of house they want, the neighbourhood, access to transit, good local schools and so on. They would hire a lawyer to inspect the title to the property, ensure that there were no liens against it and handle the closing. An engineer would probably be hired to perform a house inspection. The price paid would be compared to other recent transactions in the neighbourhood.

In other words, a house buyer expects to give the purchase serious thought, and spend both time and money to avoid obvious problems. Now, contrast that behaviour to the type of thing we see intelligent people doing in the stock market every day. Stocks are bought because of tips from relatives, friends, brokers – even from total strangers. Mutual funds are bought solely on past performance, without even looking at the kind of investments the fund makes or the level of risk the manager takes. Investment managers or brokers are given, without much insight into their competence, total discretion over someone's entire life savings.

We have a modest proposal. If you do your own direct investing, approach a stock purchase the way you would approach a car purchase. Kick the tires! Look for a few good companies at attractive prices. Find out about the business: its economics, management, track record and barriers to competition. Good investing is just common sense. For example, two of our favourite stocks, Johnson & Johnson and Rubbermaid, were purchased in part because our partners' families had personal experience with the excellence of the companies' products. If you have kids, you've probably bought a lot of J&J products and when you take out the garbage or do the dishes, chances are you've used Rubbermaid goods. This isn't exactly rocket science, just common sense. The famous Peter Lynch, star fund manager, wrote a good book about common-sense investing in 1989 called *One Up On Wall Street*.

If you lack the time or interest to do your own investing, make sure you do your homework about the investment manager you hire. Interview several different managers, check their investment philosophies, look at their track record and, most important, carefully check their references. Establish a high level of comfort before acting. Remember, the investment business is primarily about people, not just numbers.

Hyperactivity and Frictional Costs

The secret to successfully compounding capital is to hold investments for the long term. If you buy stock in a good company and hold it for a very long time, it will compound in value, and you won't have to pay tax on the accrued capital gain until you sell it. It sounds simple, doesn't it? But like most simple things, it is not easy to do.

For one thing, the whole structure of the financial industry works against it. Stockbrokers, financial planners and underwriters only make money when there is a transaction. For them, a client using a buy and hold strategy is a nightmare. They exert all their considerable persuasive abilities to get clients to do something – to do anything, in fact. Yet buying and holding is the best strategy to use in the stock market.

There is another market participant that just loves hyperactivity and profit taking: Revenue Canada. Generally, the taxman only collects when a transaction is made. We mentioned earlier the great value of buying and holding as a tax deferral strategy. Warren Buffett, in the 1993 Berkshire Hathaway Annual Report, had a valuable story on this subject of postponing taxes:

> Through my favourite comic strip, Li'l Abner, I got a chance during my youth to see the benefits of delayed taxes, though I missed the lesson at the time. Making his readers feel superior, Li'l Abner bungled happily, but moronically, through life in Dogpatch. At one point he became infatuated with a New York temptress, Appassionatta Van Climax, but despaired of marrying her because he had only a single silver dollar and she was interested solely in millionaires. Dejected, Abner took his problem to Old Man Mose, the fount of all knowledge in Dogpatch. Said the sage: Double your money 20 times and Appassionatta will be yours (1, 2, 4, 8,..., 1,048,576).
>
> My last memory of the strip is Abner entering a roadhouse, dropping his dollar into a slot machine, and hitting a jackpot that spilled money all over the floor. Meticulously following Mose's advice, Abner picked up two dollars and went off to find his next double. Whereupon I dumped Abner and began reading Ben Graham.
>
> Mose clearly was overrated as a guru: Besides failing to anticipate Abner's slavish obedience to instructions, he also forgot about taxes. Had Abner been subject, say, to the 35% federal tax rate that Berkshire pays, and had he managed one double annually, he would after 20 years only have accumulated $22,370. Indeed, had he kept on both getting his annual doubles and paying a 35% tax on each, he would have needed 7-l/2 years more to reach the $1 million required to win Appassionatta.
>
> But what if Abner had instead put his dollar in a single investment and held it until it doubled the same 27-l/2 times? In that case, he would have realized about $200 million pre-tax or, after paying a $70 million tax in the final year, about $130 million after-tax. For that, Appassionatta would have crawled to Dogpatch. Of course, with 27-l/2 years having passed, how Appassionatta would have looked to a fellow sitting on $130 million is another question.

> What this little tale tells us is that tax-paying investors will realize a far, far greater sum from a single investment that compounds internally at a given rate than from a succession of investments compounding at the same rate. But I suspect many Berkshire shareholders figured that out long ago.[44]

Many of our most successful clients have made their fortunes by owning their own companies. Usually these companies were not publicly traded, at least for the first few years. This is an enormous advantage! These private-company owners don't pay much attention to the valuation of their business, only to its operations and markets in which it operates. They get the advantage of "compounding" without "frictional costs." When they decide to sell, it usually takes a long time and involves detailed negotiations to arrive at a fair price – these decisions are not made lightly. But in the world of publicly traded stocks, you can buy or sell quickly by just calling your broker, or even transacting through the Internet. This kind of liquidity sometimes encourages transactions and activity, often to the detriment of the investor.

The advantages of long-term investing with a more reflective attitude were well explained by Buffett in the famous *Mr. Market Story* in the 1987 Berkshire Annual Report:

> Whenever Charlie and I buy common stocks for Berkshire's insurance companies… we approach the transaction as if we were buying into a private business. We look at the economic prospects of the business, the people in charge of running it, and the price we must pay. We do not have in mind any time or price for sale. Indeed, we are willing to hold a stock indefinitely so long as we expect the business to increase in intrinsic value at a satisfactory rate. When investing, we view ourselves as business analysts – not as market analysts, not as macroeconomic analysts and not even as security analysts.
>
> Our approach makes an active trading market useful, since it periodically presents us with mouth-watering opportunities. But by no means is it essential: a prolonged suspension of trading in the securities we hold would not bother us any more than does the lack of daily quotations on World Book or Fechheimer. Eventually, our economic fate will be determined by the economic fate of the business we own, whether our ownership is partial or total.
>
> Ben Graham, my friend and teacher, long ago described the mental attitude toward market fluctuations that I believe to be most conducive to

investment success. He said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his.

Mr. Market has another endearing characteristic: he doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behaviour, the better for you.

But like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice. Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence. Indeed, if you aren't certain that you understand and can value your business far better than Mr. Market, you don't belong in the game. As they say in poker, "If you've been in the game 30 minutes and you don't know who the patsy is, you're the patsy." [45]

Conclusion

We have outlined in this article a common thread running through all human behaviour patterns. Mood swings, peer pressure, restless activity, lack of foresight and impulsive pursuit of unclear goals are all characteristics of human behaviour in crowds, and it is well known that crowds sink to their lowest common denominator. For some reason, the stock market has the same effect on people. That is why great bull markets are associated with bouts of euphoria and wild speculative greed, and bear markets with attacks of black depression, fear and anger. In either case, the best approach is to distance yourself from the crowd, pick your opportunities shrewdly and buy good merchandise when it's on sale.

When you buy your stock in a good company, tuck it away and check the price on your birthday every year. (But be sure to read the annual report and vote your stock. Shareholder democracy is what it's all about these days, and even the best managements sometimes fall prey to the temptation to screw the shareholders.) Or consider hiring a trustworthy professional money manager who follows a common sense investment philosophy and stays away from the crowd.

Author: **Tony Arrell, Chairman and Chief Executive Officer**

July 1997

Great Investors

One of the main purposes of *The View from Burgundy* is to inform our readers of sound investment practices that we think enhance the possibility of long-term success. One of the ways to do this is to offer intelligent observation on some of the world's most successful investors, trying – where possible – to discern the factors that may have led to their success. Just as classical-music students would be expected to study Bach, we feel that those seeking greater success as investors would do well to study the great investors, past and present.

We think that Larry Tisch, Chairman of Loews Corporation, is one of these great investors. He is a contrarian investor who likes to buy companies that generate free cash flow. He looks at stocks as fractions of businesses and is willing to buy good assets during periods of severe weakness and pessimism, and most importantly he sticks to his discipline as a value investor.

Larry Tisch describes himself as a pragmatic investor. Here are some of his more notable trademarks:

- He performed a leveraged buyout of Lorillard Tobacco in 1966, long before the era of LBOs in the 1980s.
- He bought back about 40% of his own shares between 1981 and 1996, most of which were bought during the weak markets of 1981, 1987 and 1990. These share buybacks began long before they became popular and when they represented outstanding value for Loews' shareholders.
- He bought 100% of CBS network in the mid-1980s and sold it to Westinghouse in 1995 for a huge profit.
- He has shown an uncanny knack for buying good businesses at extremely low valuations despite predictions of their doom. For example, he bought oil-drilling rigs in the late 1980s when little or no offshore drilling was taking place.

- His capital allocation decisions have been masterly. Even though his company is considered a conglomerate, it has delivered very high return on shareholder capital.

Loews Corporation began its current corporate form in the late 1950s as a chain of movie theatres that had been spun off from MGM Studios in Hollywood. Larry Tisch and his brother, Bob, were living in Florida at that time, running a hotel they owned. Wanting to expand their hotel business, they saw a chance to gain control of Loews at a favourable price. Some of the theatres offered potential sites upon which future hotels could be constructed. Gradually they developed a chain of fine hotels including the famous Summit Hotel in New York City.

An important corporate event occurred when Loews bought 100% of Lorillard Tobacco in 1966. Lorillard was (and still is) extremely profitable as the dominant player in the sale of menthol cigarettes (Newport brand). It generated enormous amounts of cash that could be invested in other good businesses, since tobacco requires very little new capital. Larry Tisch quickly showed his mettle and became a first rate, value-oriented contrarian investor with nerves of steel. He developed a knack for buying outstanding value, especially at the bottom of an economic cycle when the opportunity for the biggest gains were the highest.

For example, in 1975 he bought CNA Financial Corp., a large property and casualty insurance company that was nearly bankrupt. Today CNA is highly profitable and is the largest of Loews' five principal businesses.

In 1979 he bought 100% of Bulova Watch and in 1989, during a very depressed oil-drilling environment, he made a substantial investment in large offshore drilling rigs. Larry's son Jim, who is gradually taking over the helm at Loews, recently stated that the oil rigs met their "$5 million test." This "test" originated when Larry stood on the main deck of one of the $100 million rigs, looked around and said: "You mean we can buy all this for only $5 million?" The rigs were available so cheaply because drilling activity was low and the owners were greatly overextended.

A brief financial overview of Loews Corporation shows that the company has revenue of about $20 billion. The book value of its equity is $9 billion but the market capitalization of the company is only $11 billion. The market price of the stock is only 20% above the book value, an extremely low ratio in today's overheated stock market.

The company pays little or no attention to quarterly financial results, and only two analysts on Wall Street follow Loews. Management in the subsidiary companies are free to run the business units independently. Head office executives are only concerned with business strategy, capital allocation and the assessment of management.

Following is a 10-year financial review of Loews Corporation under Larry Tisch's direction:

	Net Profit ($ millions)	Shares OS ($ millions)	Earnings Per Share ($)	Cash Flow Per Share ($)	Return on Equity (%)	Book Value Per Share ($)
1985	589.0	163.0	3.62	3.44	20.6	14.98
1986	545.5	161.7	3.35	3.73	18.7	18.04
1987	696.2	152.8	4.46	4.75	20.2	21.28
1988	908.5	151.4	5.97	6.48	22.1	26.60
1989	907.1	150.1	6.01	6.76	18.9	32.04
1990	804.7	139.8	5.41	6.50	16.0	36.05
1991	904.3	134.6	6.57	7.46	16.0	42.09
1992	122.6	130.2	(0.93)	0.89	(0.4)	42.45
1993	594.1	123.0	4.63	5.93	9.7	49.79
1994	267.8	117.9	2.22	3.63	5.0	45.84
1995	1,765.7	117.8	14.98	16.90	21.4	69.92
1996	1,383.9	115.0	11.91	14.51	15.9	75.92
Compound Annual Growth Rate = 15.89%						

Source: Compustat

There is a lot of value in Loews, which we think reflects the lack of extensive coverage by Wall Street, the absence of promotion by management, the conglomerate-like image of Loews and the stigma of its tobacco business.

Conclusion

So what makes Larry Tisch a great investor? We think these are a few of the key factors:

- Larry Tisch, now in his 70s, has had a lifetime of experience and proven wisdom as an investor. He buys based on value, not on fads, trends or promotion. While some think his age is a concern, we think it's a plus. (Warren Buffett says that some of his top executives only hit their stride at age 70; Phil Fisher, another great investor, is still going strong at age 89!)
- Larry Tisch recognizes the power of name brands (Newport and Kent cigarettes, Loews Hotels, Bulova Watches) and the advantages of the financial resources and leverage of insurance companies.
- The Tisch family has a large part of their own net worth in Loews. They are owners/investors. There are no stock option plans to dilute shareholder value and management compensation is fair and based upon the results achieved.

- Larry Tisch has the essential qualities of a successful contrarian investor. He has shrewd judgment, the willingness to buy when most are selling, and the courage and patience to await positive results. He is also an excellent allocator of capital, and was a buyer of his own stock well before share buybacks were popular.

Great Companies Update

In March 1996, we wrote an issue of *The View* that concentrated on the power of increasing earnings in driving stock prices and returns. We came up with a list of "super-elite" companies that had been profitable and increased their profits each and every year for six years in succession. To refresh your memories, the following stocks composed the "super-elite":

Barrick Gold Corporation	Linamar Corporation
Bank of Montreal	Quebec Telephone
Bombardier Inc.	Fortis Inc.
Imasco Limited	Unican Security Systems Ltd.
Potash Corporation	Sceptre Investment Counsel Ltd.
Renaissance Energy Ltd.	Winpak Limited
BC Telecom Inc.	Domco Industries Limited
Investors Group Inc.	Gennum Corporation
Franco-Nevada Mining Corp.	Uni-Select Inc.
Loewen Group Inc.	Lassonde Industries Inc.
Euro-Nevada Mining Corporation	Maxx Petroleum Ltd.
London Insurance Group Inc.	Premier Choix: TVEC Inc.
Metro-Richelieu Inc.	Samoth Capital Corporation
Cinram Ltd.	

We then applied a 15% return on equity hurdle to the resulting sample and came up with four companies that had both increased earnings each year over the six-year period, and had maintained a rate of return on shareholders' equity comparable to the U.S. stock market average. The four companies were Sceptre Investment Counsel, Franco-Nevada Mining, Investors Group and Premier Choix.

We thought that it would be interesting to revisit this subject and update the findings. First, we checked to see if our four winners had extended their winning streak for another year. All four had their record intact.

Then, we ran our six-year increasing-earnings screen for all companies in the database in order to see how the composition of the list would change by looking at fiscal 1991 to 1996, instead of fiscal 1990 to 1995 as we did last year. The following companies were consistently profitable and increased earnings every year from 1991 to 1996 inclusive:

Bank of Montreal	Quebec Printing Inc.
Lassonde Industries Inc.	Franco-Nevada Mining Corp.
Canwest Global Communications	Quebec Telephone
Linamar Corporation	Gennum Corporation
Cinram Ltd.	Sceptre Investment Counsel Ltd.
Metro-Richelieu Inc.	Intertape Polymer
Euro-Nevada Mining Corp.	Uni-Select Inc.
Premier Choix: TVEC Inc.	Investors Group Inc.
Fortis Inc.	Westcoast Energy

We were somewhat disappointed that the list of trailing six-year earnings winners for 1990 and 1996 had shrunk from 27 companies on the 1996 list to 18 names in 1997. Fourteen of the companies that made the 1996 list also made it in 1997, but only four newcomers were added for 1997. The new arrivals were Canwest Global, Intertape Polymer, Quebec Printing and Westcoast Energy. The 1990s have apparently been a tough time to establish a long-term earnings uptrend for Canadian businesses.

As before, we then applied the supreme test to the 1997 sample – maintenance of a 15% return on equity (ROE). The following companies were able to both increase earnings every year over the survey period and maintain a ROE over 15% in each year of the period:

Canwest Global Communications	Premier Choix: TVEC Inc.
Investors Group	Gennum Corporation
Franco-Nevada Mining Corp.	Sceptre Investment Counsel Ltd.

So, two newcomers – Canwest and Gennum – joined our four great companies. Canwest did not make the last screen because it was not a public company until 1990. Gennum reorganized in 1989-1990 and refocused its efforts on its core hearing aids business. Since then, it has not missed a beat. Gennum is a really beautiful business with outstanding management, spectacular economics and the strongest shareholder orientation we have seen in Canada. It is definitely on our "wish list" of companies to own, and we have taken a small position in the company's stock already. Canwest, of course, has been a huge winner in the broadcasting business, particularly with an amazingly profitable investment in Australian TV.

The performance of these six stocks over the last six years has been superb. The six companies averaged a total return of 37.5% annualized during that period. For comparison purposes, the TSE 300 Composite Index returned 13.6% in the same period and the S&P 500 returned (an amazing) 20.9% to a Canadian dollar investor.

Just to keep things in perspective, an investment that compounds at a 37.5% rate of return doubles every 2.2 years. To keep up this torrid pace of appreciation even for a short period of time is admirable, but to sustain it for six years is remarkable. Even allowing for a strong following wind from powerful business trends like the mutual fund explosion, niche broadcasting, and the Nevada gold bonanza, a company needs good management to build a record like that. These six businesses are great examples of how good management work together with good businesses to generate outstanding returns for shareholders.

For Whom the Bell Tolls

Those of our readers who are also clients will be aware that part of our success in Canadian equities has been due to our investments in property and casualty (P&C) insurance companies. Such stock market stars as Fairfax Financial and Kingsway Financial – and even the usually sleepy E-L Financial – have given our results a big boost in 1996-1997. Because of our great interest in this industry, we have also developed a clientele among Canadian P&C companies. This double link to the industry makes it very dear to our hearts.

But P&C companies are being fleeced by a tax grab from Ottawa, which we believe threatens the long-term viability of large segments of the industry. The law, simply put, requires financial institutions to "mark to market" their securities investments every December 31, whether or not they have sold them, and to pay tax on unrealized capital gains. As usual, a Revenue Canada attempt to get the banks to pay more taxes has largely missed the target and scored a direct hit on a much smaller and more fragile industry.

P&C companies are really just underwriting companies with an investment company attached. These companies collect premium income from policyholders, and after some period of time, pay out a portion of the money they have received as claims. In the period between receiving the premium and paying the claim, the firm must invest premium income, or "float." In order to stay in business, the firm must receive more premiums than it pays claims over the long term, and this surplus, the capital of the firm, is invested long term. Companies that are consistently successful at making money from underwriting can invest all of this surplus, as well as some of the float, in equities. So taxing them on their unrealized capital gains hits this industry particularly hard.

Why does this matter? Well, in a previous issue of *The View* ("Performance Killers"), we reprinted the famous "Appassionata Van Climax" story from Berkshire's 1993 Annual Report. The story showed that taxation is a huge issue for equity investors, since the reward for the high risks of equity investment is tax deferral on capital gains. That reward is now removed for Canadian financial institutions.

A comparison of two buy-and-hold investors, taxable at 35%, with an investment that returns 10% annually, shows the extent of the damage:

	INVESTOR A		INVESTOR B	
	Warren Buffett's Buy and Hold	**Rates of Return**	**Paul Martin's Mark to Market**	**Rates of Return**
Initial Investment	$1,000.00	-	$1,000.00	-
1 year	1,065.00	6.5%	1,065.00	6.5%
5 years	1,396.83	6.9%	1,370.08	6.5%
10 years	2,035.93	7.4%	1,877.14	6.5%
15 years	3,065.21	7.7%	2,571.84	6.5%
20 years	4,722.88	8.1%	3,523.65	6.5%
25 years	7,392.56	8.3%	4,827.70	6.5%
30 years	11,692.11	8.5%	6,614.37	6.5%
35 years	18,616.58	8.7%	9,062.25	6.5%
Present Value of Taxes Paid Discounted at 7%	**$888.47**		**$1,058.42**	

The negative effects of this legislation will only show themselves in the long term – it's not a heart attack, it's cancer. Over the course of 35 years, as you can see, the government's take from taxes is 20% greater on a present value basis than it would be under the reasonable rules prevailing in other jurisdictions. The result will be slower capital growth for the Canadian industry, higher premiums (if you raise a highly competitive industry's costs on a permanent basis, it must raise its prices or go bankrupt) and lower employment. Some long-tail insurance businesses (types of insurance that involve claims for long periods in the future) will quit Canada entirely.

This "mark to market" legislation combines several of the most unsavory aspects of taxation, Canadian style. It is utterly arbitrary and separates what should be a consequence of a transaction (paying tax) from the transaction itself (selling the security). It taxes capital gains going right back to the time of purchase of a security, and is therefore retroactive. (If your insurers bought and held Berkshire Hathaway stock 20 years ago, they would pay capital gains tax on the whole unrealized capital gain.) It penalizes the best kind of investor – the long-term holder – and encourages earnings management and uneconomic activity. We are already seeing the subsidiaries of several multinational insurers gutting their Canadian money management operations and transferring management of Canadian securities (especially equities) to the U.S. or to the U.K., which have sane tax laws. Exporting good jobs and peculiarly Canadian expertise to other countries – is this good public policy?

And finally, other Canadian investors in equities cannot view this legislation with complacency. One of the worst things about this legislation is that it is discriminatory, singling out the financial industry from other equity investors. Almost all Canadians, directly or indirectly, are now equity investors. One way to end this discrimination is to eliminate "mark to market," which is clearly the sane thing to do. Another way would be to apply it to all taxable Canadian equity investors. Maybe this is an overreaction and we are fearful of shadows, but remember, Canada did not even have a capital gains tax until 1972!

As John Donne wrote: "Never send to know for whom the bell tolls; it tolls for thee." [46]

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Selling the Downside

We returned to the subject of income trusts in this issue of The View from Burgundy, *paying special attention to governance issues that were troubling us. Managers of trustable assets were forming income trusts where the mind and management of the trusts was in a separate company that had control of the assets and managed them for fees. The fees were of course excessive and unitholders had no control over them whatsoever. We took an example of this type of fund, the Legacy Hotels Real Estate Income Trust, to show how this ugly structure benefited management at the unitholders' expense. Subsequently, managements forced the unitholders to purchase management contracts for outrageous prices, usually in the form of units in their own funds.*

This article was probably instrumental in helping to force these conversions, and as the rate of income trust issuance burgeoned, these unfair structures were abandoned. So, ironically, we may have extended the longevity and attractiveness of the income trust sector by forcing it to clean up its governance act.

Richard Rooney, 2007

A Modest Proposal

It is welcome news that the Canadian government has almost eliminated its deficit, but now we must deal with the very high debts that have been built up over the past 30 years. We feel the solution to the problem is obvious once a little "out of the box" thinking is applied to our fiscal situation. The Canadian government has a proud history of picking up the management fads of every era, after they have failed in the private sector, and applying them with comparable success in government. An outstanding opportunity to take a brilliant new product from the private sector and apply it with stunning effect is now available to the authorities at Finance. Mr. Martin and his cohorts could make history if they have the vision and boldness to use this new product imaginatively. We refer, of course, to the income trust.

The Revenue Canada Income Trust

The Canadian Federal Government has one of the world's finest streams of income on which to base an income trust. Virtually unencumbered by nondiscretionary costs, the stream of income tax receipts amounts to $80 billion annually. Increasing this stream of income has been a task at which Canadian politicians of all political parties have proven to be conspicuously successful – in fact, it is the only task at which they have been conspicuously successful.

Now, Bay Street knows a thing or two about unencumbered income. The new income trust vehicles they have been launching are based on it. With cap rates in the 8% range on fully taxed income trust products, the potential value of the income tax revenue stream is $1 trillion, or 125% of Canadian GDP. We believe that the yield-starved public would look with favour on an income vehicle based on the public's own tax payments. At Burgundy, we advocate investment in certainties, and after all, what is more certain than taxation?

The $1 trillion income fund would provide sufficient money to retire all of Canada's burdensome national debt, as well as that of the provinces. Think we could keep Quebec in Confederation by bribing it? Now we can afford to! Wait until Lucien Bouchard is offered, free and clear, a way out of his fiscal straitjacket in return for a simple business deal. Not only that, now we can bribe all the provinces to stay in Confederation. All provinces will be treated equally, just as the Reform Party wants!

Repaying our debt would immediately free up $45 billion in interest payments, those outmoded financing payments that are actually a legal obligation. The government could finance its remaining activities, if any, through the GST (unless they wanted to set up the GST Income Trust, which Bay Street – as a patriotic duty if Canada called – would design and sell for the normal 3-5%) and from its tax collections on the income trust payments themselves! Just try and avoid paying this tax! It'll be deducted at source: no muss, no fuss – $30 billion in revenues.

The provinces too can issue income trusts based on their taxation powers, in return for enormous amounts of money right now. What an opportunity for responsible public stewards of the nation's wealth.

We believe that the whole country, and especially Bay Street, is at the cusp of a Golden Age if our ideas are acted upon. Freed of debts, the country could march into the radiant future, confident that Laurier's prediction that the 20th century would belong to Canada had been fulfilled, for the last three years of the century anyway. (In the investment business, three years is known as "the very long term.") And if pressing national interests made the payment on the income trust units too burdensome, what the hell, we don't really have to make the payments. If it works for the private sector income trusts, why should the government be held to the primitive idea of mandatory payments?

Burgundy seeks no commercial gain from this proposal; we are motivated by patriotism and the desire to share with a broader public the potential of that incredible piece of financial alchemy, the income trust.

Burning the Furniture

As you may have guessed from our opening feature, the prices being paid for some assets via income and royalty trusts have exceeded our wildest expectations, but have exhausted neither the imaginations of the corporate financiers of Bay Street, nor the credulity of the Canadian public. It has truly been a situation where, as Buffett says, those who don't know are buying from those who don't care. How have these price levels been reached?

Let's consider a hypothetical example. Company A has a good, low growth, cash-generating business that requires little reinvestment in most years. The company has $1.00 per share in depreciation, and $2.00 per share in pre-tax earnings. It is currently valued in the market at $18, or 15 times earnings, the highest multiple it has achieved since its business matured. The corporate income statement looks like this:

COMPANY A INCOME STATEMENT	
Operating Income	$3.00
Minus: Depreciation	$1.00
Equals: Pretax Earnings	$2.00
Minus: Tax @ 40%	$0.80
Equals: Net Earnings	$1.20

So let's say that Company A decides to turn itself into an income trust. The first thing that an income trust structure does is to eliminate the corporate tax from the income statement. The distributions are now taxed at individual rates in the hands of the unitholders. And since individual tax rates are usually higher than corporate tax rates, the government is happy to have it so.

The second critical change between income trust and corporate accounting is that income trusts always seem to assume that some portion of their depreciation expense is excessive, and can therefore be distributed as income. Let's assume that Company A specifies that only 40% of its depreciation expense is a "real expense."

The trust income statement looks like this:

COMPANY A INCOME TRUST	
Operating Earnings	$2.00
Plus: Depreciation	$1.00
Minus: Capital Expenditure Reserve	$0.40
Equals: Distributable Income	$2.60

Assuming a yield of 9.0% on the units, the price of the units would be $2.60/0.09 = $28.89, a whopping 60% premium over what the stock market was willing to pay for the same assets in corporate form. At that equivalent price, the stock would have been trading at $28.89/$1.20 = 24 times earnings. For a mature, low growth business, such a multiple is out of the question even in the irrationally exuberant 1990s.

Observe one more thing. There is a tremendous temptation at the time of a new issue to maximize the expected payout by underestimating how much ongoing capital spending the company must make to sustain its business, let alone grow it. And, like Oscar Wilde, managements and corporate financiers can resist anything but temptation. If, for example, Company A actually needs $1.00 per share in ongoing capital expenditures, as the full depreciation expense suggests, the price of the units would be only $2.00/0.09 = $22.22, still a premium to the share price, but not a very large one.

For our part, we wonder how the accounting profession can be so wrong about how it accounts for depreciation. There is no doubt that, in some cases, depreciation does not reflect economic reality. In fact, it is one of Burgundy's techniques to find such anomalies and, where appropriate, invest in them. But they are not all that common – usually the depreciation levels are appropriate over long periods of time. Remember, in the inflationary 1970s, everyone believed that depreciation was far below economic levels, and multiples of earnings were exceptionally low to compensate. The 1970s were a historic buying opportunity for common stocks. The enormous volume of asset sales into royalty and income trusts would indicate to us that managements view the late-1990s as an equally historic selling opportunity.

A business that genuinely needs very little ongoing capital expenditure is a rare bird indeed. Oil and gas development companies, mattress companies, coal mines, hotel chains and sugar companies do not qualify, though they have all been offered into the market as income trusts this year. If they pay out their income as though historic depreciation is not a real cost, they are self-liquidating entities, not going concerns. In other words, you may be keeping the fire alight, but you're burning the furniture.

Heartbreak Hotels

We said in a previous issue of *The View* that royalty and income trusts have some of the characteristics of an insider sale. But it is an insider sale of a peculiar type: they are only selling the downside. What we are seeing in many cases are sellers realizing insane prices for assets, and also keeping control of those assets under conditions that can ensure that for management, though emphatically not for unitholders, the crop will never fail. Sell your business and entrench management? It's a dream come true!

How does it work? Well, we decided to dissect a recent income trust issue to illustrate our concerns. We chose the Legacy Hotels Real Estate Income Trust, not because it is among the worst of the new breed of income vehicles (except for its prospectus disclosure, which is, in our opinion, disgraceful), but rather because it is one of the best. Canadian Pacific Limited (CP) is bundling together its business hotels like the Royal York in Toronto, the Palliser in Calgary and the Chateau Laurier in Ottawa, and selling a REIT based on the cash flow from these hotels.

These are very good assets. They are well maintained and well managed. Many of them are familiar landmarks in Canadian city centres. While not irreplaceable, they are very well positioned in their markets. CP spent almost $31 million per year upgrading these hotels in the last decade, and it shows. But the hotel business is cyclical, though you would have to read the prospectus carefully (no easy task, since it runs to 86 pages) in order to find out. Someone in corporate finance has discovered the linguistic miracle by which a double negative gives the meaning of a fudged positive. For example: "There can be no assurance that regulatory compliance or downturns or prolonged adverse conditions in the hotel industry or real estate or capital markets or national or local economies will not have a material adverse effect on the Trust's results of operations." [47]

Translation: "Regulatory compliance or downturns or prolonged adverse conditions in the hotel industry or real estate or capital markets or national or local economies (all of which have an unfortunate tendency to occur at the same time) will have a material adverse effect on the Trust's results of operations." Is that clear? We're always glad to help.

From the prospectus, it would be very difficult to find any evidence of the last time these malign planets came into alignment. CP has provided data back to 1994, which was hardly Armageddon in the hotel business. From CP's annual report, we get the following progression of operating earnings for CP Hotels, of which the hotels in the Legacy Trust represent 45% of the revenues, and less of the profits: [48]

ROOMS AT THE TOP
CP Hotels' Operating Income 1987 - 96

1987	25.3
1988	53.0
1989	53.9
1990	58.2
1991	24.5
1992	50.0
1993	57.1
1994	72.7
1995	96.9
1996	115.8

Source: CP Hotels & Resorts Inc., Annual Report, 1996

Now why start in 1994, we wonder? Perhaps because that was the first year which could have supported a payout on the REIT units?

The Straw Man

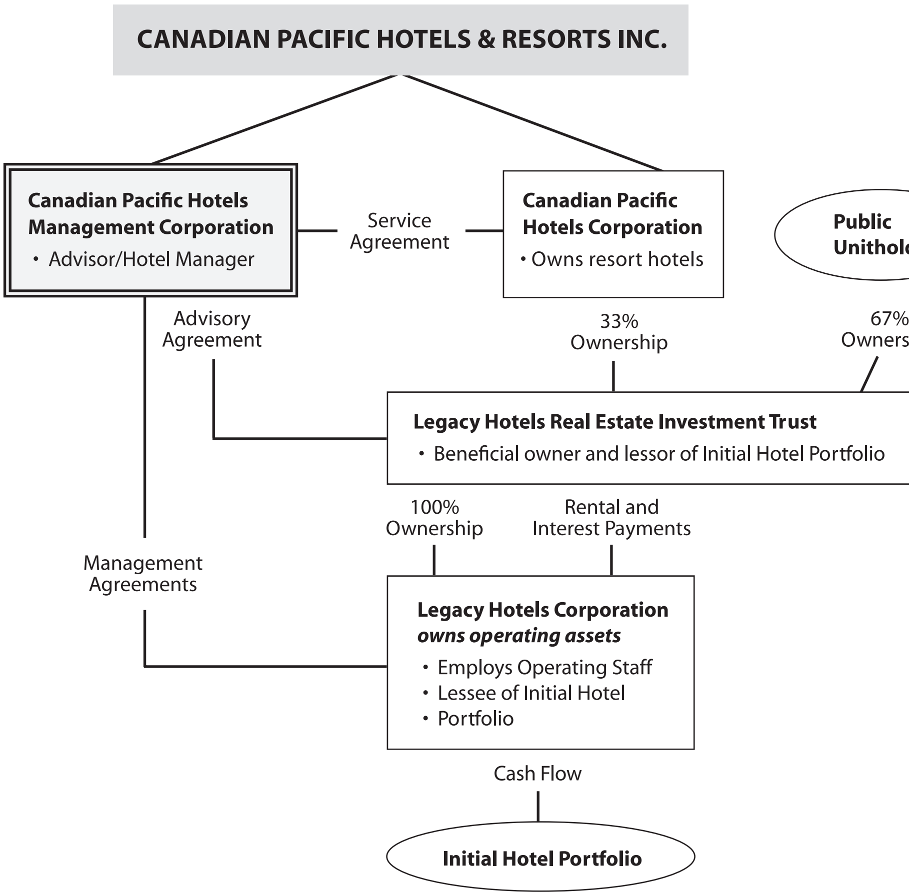
Several people have made the point that investors such as Burgundy who like to invest in companies that generate free cash flow to shareholders should really like royalty and income trusts, which do just that. But there is a crucial difference to our way of thinking. The relationship of a trust unitholder to management is entirely different from that of a shareholder in a public corporation, especially in the way most income trust deals are now being structured in Canada.

Corporate structure is straightforward – shareholders elect directors, who then appoint management to run the firm on the shareholders' behalf. However distant most Canadian companies may be from this ideal, that is the basic theory of the business corporation that has revolutionized the world over the past 300 years.

And as we have said many times before, management is the critical variable in assessing a business. A genuinely excellent management group, with its own culture and network of relationships, and its detailed knowledge of markets and operations, is the most valuable thing a shareholder owns. The dialogue between management and informed shareholders is the crux of capitalism, in our opinion, and is essential to the success of both.

It just doesn't work that way with income trusts. Managements of the assets in the income trusts are going out of their way to design structures where they do not work for the unitholders, and where their incentives are radically different from those which would benefit unitholders.

Look at the structure of the Legacy Hotels REIT.



Source: IPO Prospectus

To simplify a rather complex structure, we have highlighted the most important entity on the organizational chart, which is not, unfortunately, the Income Trust. Mind and management of the Legacy Hotels REIT reside outside the Trust, in the CP Hotels Management Corporation.

The way in which CP Hotels Management Corporation makes its money is very illuminating. It charges a 3% fee on the revenues of the hotels as a "Hotel Management Fee." It charges the Trust an advisory fee based on the undepreciated book value of the assets in the Trust. It receives a fee based on the transaction size for any purchase of new hotels and for the sale of existing assets from the Trust. And finally, it receives an

"Incentive Fee" based on any increase in "adjusted net operating income," which could, under ideal circumstances, equal 30% of the upside in such "net operating income." So the only part of management's pay that is more or less directly related to the income distribution (the only thing the unitholder cares about) is the "incentive." In a cyclical industry, the extent to which management controls increases in operating profitability is questionable, as is, therefore, their right to any "incentive" so calculated. If distributions remain flat or decrease, management will not suffer. If they increase, even though the major increases will usually not be due to management's actions, management takes up to 30% of the increase. Nice work if you can get it.

A large part of the fees will be independent of the results of the hotels. Fees for transactions and fees based on book value of fixed assets will not vary with the business cycle as distributions will. And while the revenues on which the hotel management fee is based will vary with the economy, it will vary a lot less than, say, distributable income. The vast majority of the cyclical downside will be borne by the unitholders. We feel that this is a rather asymmetrical arrangement: sell the downside, cream off the upside. If CP ever wants to take its CP Hotels Management Corporation public, it would find willing buyers. It is the really good business in this setup.

So what if you buy the units and become disenchanted with the arrangement? Can you change it? Well, no, you can't. CP effectively controls the nomination of the trustees through its holding of one-third of the units (which it is able to buy at a special price), and through a too-clever nominating committee structure. The governance of this Trust appears to us to be devoted to maintaining CP control over the assets, while realizing a monumental price for the hotels, and creaming off a good portion of the upside, if any, in the business. The unitholders are a straw man, with no management team working for them, no control over their destiny and no power to change anything important. That is the difference between a unitholder and a fully enfranchised shareholder.

It is interesting that in the U.S., this kind of arrangement is comparatively rare. It was common at one time, during the 1970s and 1980s, but the predictable and inevitable conflicts of interest that occurred forced the reorganization of the U.S. income trust industry. Virtually all U.S. income trusts now have management residing in the trust itself. U.S. investors shun arrangements like the Legacy Hotels REIT, due to bitter experience. And now it appears that Canadians will have to learn the same lesson – the hard way.

A Prophecy

We will now venture a prediction for the future of the income trust industry. First, given their structure of rewarding management for transactions, they will engage in numerous acquisitions, financing them with the sale of more units. Eventually, low commodity prices, a slow economy or business-specific reasons will reduce distributable income from the business. The trusts will be able to borrow to maintain their distributions for a time, hoping for a rebound. Finally, the management companies running the trusts will announce, with great sadness, that they will be reducing the distributions to unitholders. This will result in an unholy mess in the public markets for income trusts. Some of the lowest quality ones will go out of business entirely, while a large number of mediocre ones will reconvert to corporate form. A lot of naïve people's savings will be lost. Bay Street's name will be mud, particularly those firms that were most aggressive in selling these creations. Not just underwriters either – the companies who participated will have blotted their reputations as well.

We hope they feel that selling the downside was worth the consequences.

Author: **Richard Rooney, President and Chief Investment Officer**

March 1998

The Sun Also Rises

Burgundy's first venture offshore was to Japan. Following a visit by Messrs. Arrell and Rooney in January 1998, we became convinced that Japan offered irresistible bargains to investors. This issue of The View from Burgundy *gave the bullish case for Japan that was not being made anywhere else at the time. Generally, most of the arguments have held up pretty well. And certainly the timing was right. But the Japanese government has shown no commitment to a modernized Japanese financial system and reforms have proceeded at a dreadfully slow pace. Sadly, some of the concerns of nine years ago still linger in the Japanese environment, especially in the attitudes of managements to capital allocation.*

Richard Rooney, 2007

At the end of 1989, Japan was flying high. Its economic model was considered by many to be the best in the world. Under the benign and extraordinarily competent direction of the Ministry of International Trade and Industry, the famous MITI, Japanese companies went after markets like attack dogs and mauled foreign competitors. Stock prices had shrugged off problems in other markets and were trading at dizzying levels. With the petty cash from the massive structural trade surplus they ran with the U.S., Japanese buyers were buying trophy assets at enormous prices: Rockefeller Center, Pebble Beach Golf Course, van Gogh's "Sunflowers."

Eight long years later, the trophy assets have all been sold either to avert bankruptcy or as part of insolvency liquidation. The Japanese economy has averaged about 1% compound growth in the 1990s, and aside from the markets it dominates, like automobiles, consumer electronics, and some other technological and industrial niches, it seems to be almost peripheral to most market participants. The stock market that proudly called itself the largest in the world in the late 1980s has receded to only about 40% of its 1989 price level, while the American stock market has risen almost 200%.

Even Canada's stock market has managed to increase by about 90% in that period. Japan has been suffering through the most prolonged and severe bear market that any major stock market has seen since the 1930s.

What went wrong? In search of some answers to that question, Tony Arrell and Richard Rooney, Burgundy's Chairman and President, respectively, travelled to Japan in the last two weeks of January 1998. They visited 25 companies in their offices and saw another 30 at a conference put on by Nomura Securities. They also met with analysts, economists and strategists from Nomura, Morgan Stanley, SBC Warburg and Cazenove, as well as Canadian Embassy personnel. The basic question was whether Japan represented an investment opportunity.

There are three main reasons for Japan's appalling stock market performance: a ramshackle and poorly regulated financial system, poor capital allocation and poor corporate governance. There have been other serious problems, of course, both political and economic, but our concern at Burgundy is stock market performance, so we will restrict ourselves to strictly market-related phenomena.

Bad Banks

The banks are a millstone around the neck of the Japanese economy. They are the heart of the old, highly regulated, relationship-driven Japanese system. Each of the major banks, like Dai-Ichi Kangyo, Fuji or Sumitomo, is the head of an industrial group, or keiretsu. The group normally consists of dozens or even hundreds of companies in many different industries. The core bank provides loans at highly favourable rates to these keiretsu companies, and owns shares in all of them. The group companies in turn own shares in the banks, and in each other. If a keiretsu company gets into financial trouble, it is "rehabilitated" with the help of the lead companies in the group. Outsiders can get loans, but at higher rates of interest. Real outsiders, like entrepreneurs, often cannot get loans at all.

Japanese regulations allow for four kinds of banks: city banks, like the three referred to above; long-term credit banks, like Industrial Bank of Japan; trust banks, like Mitsui Trust and Banking; and regional banks, like Shizuoka Bank and Bank of Fukuoka. The city banks are the main providers of capital to Japanese industry through normal credit lines. The long-term credit banks give term loans for longer periods. The trust banks handle the depository business and run the pension funds. Regional banks are supposed to provide credit to small- and medium-sized businesses. A corporate bond market does not really exist; the bond market mainly deals in Japanese government bonds. So interest rates are not set by a free market, but by a combination of regulations and relationships.

This system worked quite well until the bubble economy of the late 1980s. At that point, with apparently limitless amounts of money to be made in real estate, the Japanese banks began to funnel more and more money to real estate and construction firms in the hot markets of Japan. At the peak in 1990, with Japanese real estate at surreal price levels (everyone seems to recall that, in theory, the grounds of the Imperial Palace in Tokyo were "worth" as much as all of California), the Japanese banks had loans outstanding to these companies for 500-1,000% of shareholders' equity. The security for these loans was real estate at grossly inflated prices.

As reality set in during the early 1990s, the Japanese government colluded with the major banks in window dressing their loan portfolios. "Stimulus packages" totalling US$570 billion were undertaken to keep the economy growing, but also to give the real estate and construction sector the wherewithal to continue paying interest, since most of the "stimulus" occurred in this sector. Lax regulation allowed the banks to be very coy about their non-performing loans, and there was no pressure for write-offs from the Japanese Ministry of Finance or the Bank of Japan. Even the Bank of International Settlements got into the act, allowing the Japanese banks to count as equity their unrealized gains on the enormous stock portfolios they held in keiretsu companies.

Looking at this cozy, expedient and unreal arrangement, one is reminded of Pierre Laval, the Prime Minister of Vichy France, and his address to the collaborationist Chamber of Deputies after D-Day, in which he said, "Gentlemen, we are all up to our necks in manure, so nobody splash." [49] That was very much the attitude of the Japanese bankers and financial officials.

The market splashed for them, as it has a tendency to do. The relentless downward spiral in property prices eroded the collateral base of the loans, while the slide in stock prices weakened the capital base of the banks as their unrealized capital gains disappeared. Non-performing loan balances began to rise even under the poor disclosure rules of Japanese banks, and the capital erosion forced the contraction of lending. The result has been a ferocious credit crunch, aggravated by the tendency of Japanese banks to continue to lend on the basis of relationships rather than risks. This has led to a peculiar situation where interest rates are extraordinarily low, but loans are unavailable to most borrowers. Until this rationing system is replaced by a system that distributes money based on interest rate spreads between different credit risks, as in most other areas of the world, Japan will continue to wallow in a low growth, quasi-recessionary environment.

Ironically, if the $570 billion in stimulus packages had been put aside to restructure the financial system rather than to help some overleveraged construction companies, Japan today would be in much better shape. It would be able to play its appropriate role as senior regional economy in the Asian crisis and the world would be a safer place. But the half measures of government policy seem to have no end.

Bad Capital Allocation

Readers of *The View* know that we have a major problem with companies that allocate capital in inefficient ways. Unfortunately, that includes most of corporate Japan. The problem is twofold – a culture of employee entitlement and a surprising lack of financial sophistication.

Modern Japan's economic policies are based on an implicit deal between industry and government. The government provides a rudimentary welfare state and pro-business regulation, and business provides lifetime employment and social benefits including housing, health care and education. This implicit lifetime employment guarantee is why Japanese companies are always looking for new markets and products in which to deploy surplus labour. Where a North American company in a mature industry would be looking to downsize that business or perhaps exit it altogether, in Japan, the management would only do such a thing if it were faced with immediate bankruptcy. Normally, they would look to start a new line of business in order to second workers from the original one. Another factor is that managements are paid based on the size of the workforces they manage rather than profitability, which makes downsizing even more difficult for them.

Within these constraints, Japan has done a good job of maintaining employment. But the cost has been to keep alive large industries that in other economies would have been forced to restructure or disappear. In North America, such companies would be starved for capital until they were able to earn a decent rate of return on reduced capital bases. In Japan, they get loans from group banks and continue to operate. So again, the banks are the main culprit.

All companies, in all industries, use this employment system. The basis of the whole system is seniority. At Kyocera, one of Japan's leading high-technology companies, we asked what would happen if two engineers were hired at the same time, with one proving to be an average performer and the other one a star. After 10 years, how much would the two make? The rather puzzled answer was that they would make about the same amount, but the more talented engineer would have a higher position in the firm than the average performer. In Japan, being entrusted with higher responsibilities is the reward, not increased salary. But at this company, as at many others, we were told that the company was hiring "mid-career managers" from other firms, which was unheard of until recently.

This employee entitlement system is a major barrier to capital efficiency, not so much because it makes labour markets so rigid, but because it dilutes the concept of return to shareholders almost out of recognition. New projects are reviewed mainly on their ability to generate near-term employment rather than long-term returns. As a result, concepts such as return on investment, discounted cash flow and cost of capital are almost unknown and rarely used in Japan. Not surprisingly, most Japanese companies have balance sheets that bear no relationship to the risks inherent in their businesses, and have returns on equity that average about 3%.

And obviously, when you are constantly looking for new businesses to get into, and you may or may not be able to get money from the bank, it is only wise to keep a plentiful supply of cash on hand. A great many Japanese companies have very large cash hoards on which they can sit for decades. From a return on capital viewpoint, this is a disastrous decision.

Archaic government policies also prevent Japanese managements from allocating capital efficiently. For example, the Japanese tax code discriminates against dividends from corporations to individuals, so special dividends are an expensive and inefficient way to return money to shareholders. And stock buybacks were illegal until late 1994, and are still comparatively rare.

Bad Corporate Governance

Managements in Japan do not generally feel that they work for, or are in any way responsible to, the shareholders as a group. Where there are major keiretsu shareholders, there is a strong sense of obligation, but minority shareholders are usually ignored. Indeed, so intense is the aversion of Japanese managements to embarrassing questions raised by minority shareholders that almost all Japanese companies hold all of their annual meetings on the same day of the year, at about the same time of day. More preposterous still, a blackmail industry has sprung up in Japan of people who threaten to disrupt annual meetings and will instead "protect" it for a large fee. These exploiters of the Japanese fear of embarrassment are called "sokaiya." Japanese managers would be amazed at the pointed questions and outraged filibusters that are such a common feature of North American annual general meetings.

Boards of directors in Japan are huge, cumbersome and inbred. Outsiders are shunned and Board appointments are rewards for long service rather than strategic appointments designed to improve the business. We asked several Japanese managers how the Board was elected, and all said that it was appointed by management.

While Canadians cannot cast the first stone here, with so many ineffective, management-appointed Boards of our own, the Japanese situation is much worse.

Managements could be forgiven much if they just owned some stock themselves. But they usually own none at all. Options plans, which have grown so common and so large as to become an abuse in North America, were not legal in Japan until recently. So management, with no stake in the company, no sense of responsibility to shareholders outside the keiretsu, no real guidance or correction from the Board, and usually no need for equity financing, does exactly what it wants to do with the business.

Darkest Before Dawn

Does this sound like a buy story so far? Probably not. But there is another side to the story. Japan did not achieve its miraculous economic development by accident. Remember, this is a small island group, remote from all other large capitalist economies, with little in the line of natural resources. Its society and economy, as recently as 1868, was feudal in structure and resembled that of a European country in 1600, except for a vastly higher general level of personal hygiene and aesthetic taste. One hundred and thirty years later, it is a true colossus, a world economic power.

Japan's only great natural resource has been its people. They are industrious, cooperative and disciplined. They are true believers in education and self-improvement. And they have shown an amazing ability to learn and adapt.

This is perhaps the most instinctively collectivist society in the world. Everything must be done by consensus, and there is not yet a consensus on what changes Japan must make to restore its position. So on a macro level, Japan may continue to stumble toward a solution for a long time, with a sick banking sector dragging down growth levels. There appears to be little hope for a Resolution Trust type of package to put the current system out of its misery. When a solution does appear, it will be peculiarly Japanese and probably quite effective, but there is no sign of a public policy consensus anytime soon.

But on a micro level, there are signs of life. In 1995, two Japanese companies bought back their stock. In 1996, 12 companies did. Last year, 117 announced stock buybacks. Several Japanese companies are reducing the size of their Boards of Directors, and some are even appointing outsiders. An increasing emphasis on return on equity is apparent from a reading of recent Japanese annual reports and our meetings with Japanese managers. Modest stock option plans have been introduced by a number of Japanese companies.

Deregulation is taking place everywhere in Japan. This is one of the most highly regulated societies in the world, and the red tape is coming off, though slowly.

Indeed, the scope of deregulation in Japan is so comprehensive that we see it as a sort of slow motion revolution. In banking, insurance, retailing, health care and telecommunications, to name only a few sectors, the old system is dying, and a new one has yet to take shape. But the new system will be more market driven than the old one; that is for certain.

The Japanese are among the world's great savers. They have the world's largest pool of liquid savings in bank accounts earning microscopic yields because they are only interested in return of capital, not in getting competitive returns on capital. Japanese liquid savings, including pension funds, amount to over US$9 trillion, and only about 7% of those savings are invested in equities. In North America, almost everyone has exposure to the equity markets, either directly or indirectly. In Japan, almost nobody does. The army of potential equity buyers is huge, and it has a lot of ammunition. The mutual fund industry is tiny, though that will change with Fidelity and Merrill Lynch about to enter the market.

Japan is a neglected stock market. When we attended a Nomura conference, we were startled at the youth of many of the participants. On enquiring, we were told that Japan had been such a bad market for so long that new hires in money management firms were immediately given the Japan file by the previous rookie, who gratefully graduated to analyzing a market that sometimes went up. Most money managers have been underweighted in Japanese stocks for their entire careers, and for the last eight years that has been a good decision.

Japanese stocks are undervalued. One in eight Japanese stocks is a "net-net" – the classic Ben Graham investment, where if current assets were used to pay all liabilities, there would still be more cash per share left over than the current stock price. One in three listed stocks trades at a discount to book value. Dividend yields higher than the 10-year bond yield (admittedly a tiny 1.5%) are common.

Conclusion: Buy

Value only appears when things look bleak, and things look very bleak in Japan in early 1998. We think that the overwhelming pessimism with which Japan is viewed presents an opportunity. The contrast to North American markets could not be greater. Mr. Market is manic on America and depressive on Japan. Given a clear choice between the North American markets (where conditions are ideal for equity investors) and Japan (where problems are so very evident), most people would not hesitate to invest in America. Yet it is the prospect of improvement that ultimately drives equity prices, and how much better can it get in the U.S.?

The risks in Japan are short term, and they may be substantial. A real old-fashioned financial crisis could lead to very poor short-term stock market performance. A weakening yen could exacerbate the situation. But to some degree, these risks are known and discounted in stock prices. And a crisis may actually give rise to the consensus that is necessary for action in Japan and that has so far eluded the country.

Japan's great strengths are being overlooked, and its weaknesses exaggerated. Value plus neglect equals opportunity. Japan is a buy.

Author: **Richard Rooney, President and Chief Investment Officer**

May 1998

A Capitalist Hotbed

Continuing our bullish cases for overlooked and under-researched venues, we turned to Quebec. It is probably fair to say that Burgundy's fine performance in Canadian equities in the 1990s was substantially due to investments in Quebec stocks. Allan MacDonald was always extremely impressed with the calibre of managements in Quebec and argued for an issue of The View from Burgundy *on the subject, especially in the atmosphere of undervaluation prevailing after the October 1995 referendum. We translated this issue of* The View *into French (something we now routinely do, of course) and it attracted some favourable attention among the business and financial community in Montreal.*

Richard Rooney, 2007

One Canadian province has led all others in small- and mid-cap stock market performance over the past two years. Two of the three top performing Canadian small-cap mutual funds over the last year invest exclusively in this jurisdiction. It is a motherlode of fine, underfollowed companies at reasonable valuations. It has a pro-business culture and a union movement that is focused on international competitiveness. The population of the province overwhelmingly approved of the Free Trade Agreement with the U.S. We refer, of course, to the province of Quebec.

The Canadian media and Canadian politicians spend a great deal of their time finding political or economic reasons why Quebec should stay in Canada. From our focus on the stock market and its publicly traded companies, Burgundy takes a different tack – Quebec's departure would be a blow to all Canadian investors because it might make it more difficult to invest with some of the most dynamic and creative management groups in North America. Our subject in this issue of *The View* is one of the best-kept secrets in Canada – the fine companies and terrific stock performance that are offered by equity investments in Quebec.

It is a sad truth that companies only really learn to compete during tough times. In Quebec, capital and population flight have so suppressed economic growth that any management whose company has been able to grow and prosper really must know its stuff. A generation of business leaders has grown up in Quebec without being able to count on strong underlying economic growth to bail out bad decisions. The result is a tough, pragmatic group of entrepreneurs who can be relied upon to make money in just about any circumstances.

Part of their success has been in their closeness to their customers. The old Anglo business establishment in Quebec catered, naturally enough, to the Anglo minority. The new entrepreneurs know the market in French Quebec and have built strong businesses serving local tastes. Another factor is that they are pioneers – they haven't learned many of the bad habits that have plagued English Canada's business community: the complacency and timorousness that have characterized so many of Canada's largest companies. Lastly, they tend to own big positions in their own companies, so their interests are aligned with other shareholders. They usually got their stock the old-fashioned way: by investing seed capital in the business, rather than through options.

An Embarrassment of Riches

So who are some of these companies and their leaders?

Uni-Select ($27)

Five-year compound return: 29.2%. Five-year average return on equity (ROE): 21.3%. Five-year compound growth in pre-tax income: 23.2%. Price-to-earnings ratio on trailing earnings: 15.1 times.

If we had to pick a favourite stock at Burgundy on the Canadian Equity side, Uni-Select would probably win. It performs brilliantly yet never gets overpriced. Even now, after a terrific run, it is one of the cheapest stocks in Canada.

We wrote about this wonderful company and its crack management team in a previous issue of *The View* ("Capital Punishment Part II"). As one of Canada's wholesalers of aftermarket auto parts, Uni-Select is in a rather humdrum business. But by attention to detail and clever program design, the company manages to earn returns for shareholders that are outstanding. The price-to-earnings ratio for this company has never reached the TSE average, yet its returns have been absolutely spectacular. Jacques Landreville, the affable and capable CEO, must find this discount frustrating, since it does no justice to his excellent management team and its great achievements. Since Uni-Select actually generates more than 60% of its revenues and profits outside Quebec, the reason most often given for the discount is invalid. We would argue that a premium is appropriate, given the track record of this company.

Metro-Richelieu ($16.75)

Five-year compound return: 28.5%. Five-year average ROE: 19%. Five-year compound increase in pre-tax income: 20%. Price-to-earnings ratio on trailing earnings: 12.6 times.

Metro-Richelieu is Quebec's second largest food retailer/wholesaler. This is a true Quebec stock – virtually all sales and profits are earned in Quebec. But what profits! The company's margins and other productivity measures compare favourably with those of Loblaw, but the stock sells at less than half Loblaw's multiples.

Pierre Lessard, Metro's Chief Executive, is a terrific merchant who has gone from strength to strength since joining the company in 1991. The company uses franchisees for most of its business, with the exception of its Super-C store, which is the big-box corporate format. The franchisees have fairly small stores on average, but are very close to the customer and willing to invest in their businesses. Some of the discount in the stock is due to the entry into the Quebec market of Loblaw in the Montreal market and Sobey's from the Maritimes. These are marginal threats in the medium term, however, since neither new competitor will have critical mass in the Quebec market for a number of years.

One great advantage of having a cheap stock is that when it is bought back, the accretion of value for shareholders is very large. Metro bought back over 20% of its stock through a Dutch auction in 1996, and has been able to post ongoing 20% plus earnings per share increases as a result. As long as the market is unwilling to recognize the value in this company, Metro-Richelieu will probably continue to be a buyer of its own stock, and we will continue to benefit.

Radiomutuel ($15.50)

Five-year compound return: 37.2%. Five-year average ROE: 4.3% (currently 14.3%). Five-year compound rate of growth in pre-tax income: 36.7%. Price-to-earnings ratio on trailing earnings: 41.3 times.

There is no better turnaround story in Canada than the turnaround story in radio. From a period in which AM radio was an unmitigated disaster (which accounts for Radiomutuel's low five-year average ROE), we are moving into a period where radio will be a licence to print money. Due to proposed new CRTC regulations allowing ownership of multiple stations in individual markets, tremendous economies will be realized in the Canadian radio business. And nowhere is the story more dramatic than in Quebec. Essentially, two players – Radiomutuel and Telemedia – share the Quebec French market. Telemedia, after 11 years of bungling, was able to persuade some very short-sighted, but very large shareholders to sell their positions for a song last fall, and the company went private. Burgundy held too small a position to be able to contest the takeover, but it still rankles. At least it was the mismanaged company that disappeared, and not Radiomutuel.

Norm Beauchamp, Radiomutuel's chief executive, is yet another example of the kind of smart, no-nonsense executive that Quebec seems to produce in batches these days. (We should mention that there is almost always a crackerjack CFO as well. At Radiomutuel, the CFO is George Rossi, at Metro it is Serge Gadbois, and at Uni-Select, it is Jean Guenette.) M. Beauchamp and his partner have put together a very good collection of communications assets, including not only 11 radio stations, but also several specialty TV channels such as Musique Plus (the French version of MuchMusic), and a billboard business that is the little-known crown jewel of the company.

Billboards are a fantastic business. For a modest capital investment, a company can possess an asset that generates strong cash flow for an indefinite period. Payback for billboards, while varying depending on the location, is usually less than two years. And prices being paid for billboard companies by acquirers are sky-high, with 12 times cash flow being a common price. Radiomutuel is the only public play in Canada in this great business, through its Omni subsidiary.

The return on this stock has been extraordinary, and current valuation is extended, but earnings are still growing strongly and we feel that Radiomutuel is just getting started.

Honourable Mentions

That is just a small sampler of the delights that await the equity investor in Quebec. We have not talked about Jean Coutu Group. We had the honour of meeting M. Jean Coutu in person during our last trip to Montreal. (We should mention the extraordinary openness of these managements to shareholders and potential shareholders. M. Coutu gave us well over an hour of his time, and we learned a great deal. Unfortunately, we didn't buy his company's stock, which has since done brilliantly.) From one corner pharmacy in Montreal, M. Coutu has built a very large and very profitable pharmacy chain that competes successfully in both Canada and the U.S. He received us, as is his wont, in his white pharmacist's jacket, and spoke wistfully about getting back behind the counter some day.

Nor have we discussed GTC Transcontinental, a large printing company of which M. Remi Marcoux is Chief Executive Officer. M. Marcoux is a man of great charm and humour, who will tell you that he has only two investments: his house, and his 11 million shares of GTC. He is too modest to mention that the latter has increased in value from $1 (when he bought a small printing company out of bankruptcy) to about $175 million over the past 22 years. Pretty good investing, we'd say.

We have not discussed San Francisco Boutiques, the best fashion retailer in Canada. M. Paul Roberge has designed a new department store format called Les Ailes de la Mode and has opened three locations in Quebec. All are doing brilliantly, and deservedly so, as we would judge from our visits. Again, we think that this shows the vibrancy of the Quebec business culture. Who would have thought that in the brutal retail environment of the early 1990s, someone could come up with a powerful and very profitable new department store concept?

Videotron, Logistec, BMTC, Maax, Couche-Tard, Van Houtte: we have only scratched the surface in our discussion of Quebec's small- and mid-cap attractions. And there are some superb investors based in Quebec as well. Everyone knows about the great Paul Desmarais, but fewer people have heard of Charles Sirois, whose record is scarcely less impressive, especially given his relative youth. These are people that one can invest alongside with great confidence.

Long live Quebec free enterprise!

A New Leaf

In June of 1995, we wrote a comparison of Imasco and Rothmans, Canada's two publicly traded tobacco companies. The comparison was most unflattering to Imasco, which at that time was feeling the aftereffects of a long "di-worse-ification" spree. Taking cash flow from the tobacco business, which despite its unpopularity is a superb cash flow generator, Imasco bought companies in financial services, fast food and pharmacy retailing, rather than returning the cash to shareholders. The result was a decade of mediocrity.

Rothmans, by contrast, stuck to its core business and returned cash to the shareholders through regular special dividends. The result was a decade of sparkling total returns to shareholders. The contrast between these companies' performances in the stock market despite the similarity of their base businesses was what caused us to use them as the subject of *The View*.

We are very pleased to say that, since then, Imasco has turned over a new leaf. A dramatic restructuring has occurred since mid-1995, and has caused a distinct change for the better in the fortunes of its shareholders.

The turnaround may have already started when our article was published. Mr. Brian Levitt had been appointed President and CEO of the company at the beginning of

1995, and some good things were happening within a few weeks of his appointment. For example, in July of 1995, the company announced a four million share buyback, the first of several undertaken since. And in the autumn of that year, rumours were rife of a pending divestiture of Hardee's, the troubled restaurant chain that had cost Imasco shareholders so much in profitability and performance. Hardee's Roy Rogers restaurants were put up for sale at year end 1995, and the deal was completed in August 1996. The Annual Report for the calendar year 1995 had a very strong stress on Economic Value Added, which has continued to the present day and is usually a good sign for shareholders. The dividend was raised in February of 1996, and again at the beginning of 1997, so shareholders began to see some cash from this cash flow machine.

The remainder of Hardee's was disposed of in July of 1997, leaving an Imasco composed of Canada Trust, Shoppers Drug Mart and Imperial Tobacco. There have been repeated denials that Imasco is interested in selling its Canada Trust unit.

The stock performance has reflected the improvement in capital allocation strategy at Imasco. For the one-, three- and five-year periods ending March 31, 1998, Imasco stock returned 68.1%, 41.5% and 28.1% compound, respectively. The comparable numbers for Rothmans are 44.5%, 38.8% and 26.1%. Over the same period, the TSE 300 returns are 31.3%, 22.9% and 18.5%.

So that is the happy ending to our story. When a management with good assets starts to manage them in the shareholders' interests, the results can be most gratifying for all concerned. We await the really gutsy call from Mr. Levitt and Company: Why does Imasco exist at all? Each of its units is attractive on its own (though Imperial Tobacco, with 25.7% operating margins and a 94.7% return on assets, is the crown jewel) so why not set them loose to grow and thrive on their own?

Author: **Richard Rooney, President and Chief Investment Officer**

August 1998

Stealing a Fortune

From undervalued jurisdictions, we turned our eye to a subject that was becoming more and more dangerous and outrageous – the stock options binge that America was on in the 1990s. Due to a loophole in U.S. accounting standards, stock options could be granted in vast profusion without accounting for them. Managements took advantage of this loophole and granted themselves enormous options packages that enriched them beyond any reasonable concept of renumeration for their services. Very often, those who received these packages did not in fact do a very good job for shareholders. It now appears that many of these same managers, not content with options packages in the tens and even hundreds of millions of dollars, stacked the deck by backdating them so they were assured of extra value. Their greed was boundless.

We looked at the behavioural and financial aspects for executive stock options and strongly opposed their use in any form, at least until they were completely accounted for. Yet it took the expensive and sleazy scandals at Enron and WorldCom to show just how dysfunctional options were as a means of incentivising and compensating management. And it was 2003 before expensing of options became mandatory.

Richard Rooney, 2007

It is not too much of a stretch to say that the biggest change in management behaviour over the past 20 years has been the transformation of senior managers from stewards of businesses into shareholders and option-holders of those businesses. Under the stewardship approach, the management took sort of a “father knows best” attitude to the shareholders and their interests. In a market where control of companies tended not to change hands through takeover bids, they attempted to hand down to the next generation of managers an intact corporate culture, a strong balance sheet and a business much the same as the one they inherited. Title, prestige, job security and association with the company name were more important than monetary compensation, which was adequate, but by no means excessive. Shareholders were treated politely but not taken seriously. Longtime shareholders of the Canadian banks will recognize this style of management.

From our standpoint, those were not the good old days. While the stewardship approach to managing a public corporation tended to be safe and ethical, it was extremely risk averse and often led to inefficient use of the shareholders' resources. We have always believed in the power of capable management in a good business, under proper incentives, to generate excellent returns. And the best possible incentive is for management to own part of the company along with us. But we have major concerns with the way management is acquiring its shares.

It used to be said, "You can win a fortune, and you can inherit a fortune, and you can steal a fortune, but you can't earn a fortune." Nowadays, American managers can expect to retire with enormous wealth as a result of the options plans that can earn them hundreds of millions of dollars in their careers. Executives like Sandy Weill of Travelers and Michael Eisner of Disney will be among the richest people in America when they retire. Thousands of others will be wealthy beyond most people's wildest dreams of avarice. The vast majority of this wealth has been generated by Employee Stock Option (ESO) plans. Our question is this: Is the old saying true? Or do ESOs permit managers to earn their fortunes at nobody else's expense?

The raw numbers are staggering. Managers of the 350 largest U.S. companies realized over $1 billion in options gains in 1997. Gains from vested, but unexercised options in those companies exceed $7 billion. Over the past five years, the total value of all options they have issued is over $45 billion, increasing 500% over that period. The 200 top American companies now have reserved 13.2% of total shares outstanding on average for options issuance, double the proportion in 1989.

In this issue of *The View*, we will look at the nature and history of options. We will then use an illustrative example to assess ESOs as a long-term incentive system. Finally, we will summarize our beliefs about options and where we, as long-term shareholders, should go from here.

The Nature of the Beast

An option is the right, but not the obligation, to buy a share of stock at a fixed price sometime in the future. Exchange-traded options are usually based around the current market price of the underlying stock, and have terms of weeks or months. Employee Stock Options, by contrast, often have terms of 10 years. After some period, ESOs "vest" and become the property of the option holder.

Exchange-traded options are very risky derivative securities that will expire worthless at the end of their term if the market price of the shares stays below the strike price of the option. So too will ESOs. The problem is that the long terms of ESOs, coupled with the habit of issuing them at current market prices, makes it highly improbable that the ESO holder will suffer the common fate of the exchange-traded option holder and be left with a worthless piece of paper.

Think about it. In the past 75 years, there have been exactly two 10-year periods in which the return on large-capitalization U.S. companies has been negative. Those decades were January 1, 1929 to December 31, 1938, and January 1, 1930 to December 31, 1939. Given enough time, the stock market can recover from lost wars, depressions, oil shocks and just about everything else that can be thrown at it. And while the fates of individual corporations are obviously far more various than the gross statistics suggest, it is safe to say that a 10-year option on an established, publicly traded corporation is a pretty good bet. In a great bull market, it's a no-brainer.

So how did Employee Stock Options take over corporate America in the past 15 years? Well, ESOs are by no means useless. In cases where there is substantial risk and a lack of cash, like startups and leveraged buyouts, they are a superb way of motivating and empowering management. A good case can be made that America's technology sector, the envy of the world, was built on a foundation of stock options. Thousands of techies accepted derisory salaries and worked insane hours to launch their companies in return for a piece of the action. Many made and lost several fortunes this way.

The corporate raiders of the 1980s usually found themselves with highly leveraged businesses where the margin of safety was thin and good managers were necessary to keep the business on the rails. They found that the best way to attract this management talent was to offer them lots of options. Options grants of millions of shares of stock to single individuals were pioneered by the Carl Icahns, Ron Perelmans, KKRs and Wasserstein Perellas of the 1980s.

As the great bull market roared on and on, more and more corporate executives got on the options bandwagon. Interestingly, the last time the stock markets were very sloppy for a prolonged length of time – in the 1970s – executives wanted cash, cash and nothing but cash. But with options fortunes being made all around them, more and more companies initiated ESO schemes. ESOs began to be adopted by large, established companies with little risk of bankruptcy and no shortage of cash. What was in it for these companies, that they adopted ESO plans so enthusiastically?

The ultimate attraction was that options gave managers a chance to get rich without the shareholders being any the wiser.

Now, accounting issues are real eye-glazers. Prolonged thought on the subject of options accounting leads only to the sincere wish that someone had written one of those "Options for Dummies" books on the subject. But this is the central issue here, so we beg your indulgent attention.

If a payment is made out of a company's bank account, it is eventually expensed through the income statement, with very few exceptions. But options are not a cash outlay of the company. They are issued out of the liability side of the balance sheet, from shareholders' equity. Normally, the issue of shares results in cash or other assets being acquired by the company for the benefit of all shareholders; in this case, the cash from the sale of stock is pocketed by management. In effect, the company grants the employee the right to do a share issue with the proceeds going to the option holder rather than the company.

It is this rather peculiar nature of options that has prevented the accountants from coming up with a sensible way to account for them. They have ducked the issue completely in Canada, unlike in the U.S. where some attempt has been made to relate options to corporate income. In Canada, the existence of the options is disclosed in a note to the audited financial statements. And that's it. The only way the shareholder sees the impact of options is as one of those phantom dilutive factors in calculating earnings per share.

A Free Lunch

Why should we care? Well, as shareholders, we are entitled to whatever is left of a company after everyone else takes their share. We have the right to the residual value of the company, and if it is managed right, that residual value increases over time. Think of a corporate income statement as a line-up in the cafeteria. Our customers provide the food. First in line to eat are our line employees and suppliers. Then our staff employees, managers, accountants and lawyers. Then our bankers and bondholders. Then the government takes its share. Finally, our preferred shareholders take some. And whatever is left, theoretically, is ours. Options give managers the chance to go through the line at the cafeteria twice. First, they go through as employees, collecting their salaries and cash bonuses. Then, they have the right to go through a second time as shareholders. In practice, they usually sell that right to others, but since they don't have to have their ticket punched for the second trip, it's a free lunch for the option holders.

This is the really objectionable thing about options accounting, or rather the lack of it, in Canada. That right to line up for a second time in the cafeteria is clearly a valuable thing. And it is, equally clearly, a key part of management compensation. Yet it will never show up in compensation expense. So arguably, corporate earnings are overstated by the amount of options gains.

What would happen if those gains were charged against income, as they clearly should be, as part of compensation expense? Well, in our example, management would now make only one trip through the cafeteria line-up. But they would take a great deal of food. And the vital residual, net income, would be severely reduced as a result. The extent of that reduction is a controversial topic that is outside the scope of our discussion, but the existence of any overstatement of earnings is a matter of grave concern.

When the Financial Accounting Standards Board (FASB) in the U.S. attempted to make companies expense a portion of their options a few years ago, they were roundly denounced as saboteurs who were trying to destroy America's great enterprise culture, and (even worse) make the stock market go down. No question of propriety of reporting or honest disclosure; just (literally) vested interests preventing their ox from being gored. And since the constituency for honest accounting and disclosure is minuscule compared to the hordes who have options, the FASB beat a hasty retreat. They salvaged something, however, since U.S. companies must now disclose the value of the options granted as calculated by the Black-Scholes method. So at least some attempt has been made in the U.S. to place a value on the options that have been granted to the managements of companies with ESO plans. The Canadian Institute of Chartered Accountants (CICA), dedicated to a quiet life, has made no such attempt.

So that is the accounting controversy in a nutshell. Options do not affect the bottom line on which managements' performance is measured, so they employ them aggressively. That alone would be sufficient grounds for objection, since accountability is the single most important issue for long-term investors. But beyond that issue, we object to options issuance because options cause managers to behave in ways that are not in their shareholders' best interests. So what is the difference between an owner-manager and a manager with options? The following simplified little parable should make that distinction plain.

A Tale of Two Companies

Two directors' meetings are held in August 1988 by companies in similar businesses. One is a Board meeting of Excellent Corporation, the other of Subpar Corporation. The subject is long-term incentives for top management. Excellent Corp. and Subpar Corp. (all names have been carefully chosen to conceal any bias Burgundy may have) have decided that Mr. Topnotch and Mr. Hohum – their respective newly hired CEOs – should receive long-term incentives tied to the company's stock price. Excellent Corp.'s

Board has carefully thought through an approach that it believes will lead to the most shareholder-friendly behaviour by its CEO over the long term. Subpar Corp.'s Board has adopted a standard Employee Stock Option plan. Both Boards have decided that the amount of long-term incentive bonus should be about 500% of salary, which in this case is about $2.5 million. The stocks of both companies are trading at $10 per share.

Subpar Corp. will grant Hohum a 10-year option to buy 250,000 shares of Subpar at $10 per share. The options will vest after five years, after which Hohum may exercise his options at any time.

Excellent Corp. grants Topnotch a $2.5 million bonus contingent on his using the after-tax amount to buy shares in Excellent Corp. in the stock market. With the after-tax proceeds of his bonus, he purchases 125,000 shares of Excellent Corp. His stock will also vest after five years, after which he may sell his stock at any time.

Topnotch buys his stock in the market, as all other shareholders must. When the time comes, Hohum's stock from his options exercise will be issued at a fixed price from treasury, a privilege granted to no other shareholder.

Topnotch's bonus is incorporated into the compensation expense of Excellent Corp. in its reporting to shareholders. The existence and terms of Hohum's ESOs are disclosed in a note to Subpar Corp.'s financial statements. Excellent Corp. has accounted fully and honestly for a valuable asset that has been acquired by an employee. The ESO granted to Hohum will never be charged against Subpar Corp.'s earnings.

Excellent Corp. gets a tax deduction for the bonus it has paid to Topnotch. Subpar Corp. receives no tax deduction for the ESOs that Hohum has received.

The taxation issue is also important when looking at the position of the two recipients. Topnotch's benefit was front-end loaded for tax purposes – he paid his taxes but now owns his stock outright. He will be able to enjoy the tax-free compounding from holding the stock for the long term. He only faces the dire prospect of further taxes payable if he sells the stock. He is in exactly the same position as any other long-term shareholder. By contrast, Hohum's benefit is back-end loaded. He faces a stiff tax bill when he exercises his option and buys the stock.

Topnotch knows exactly what his incentive is worth on a given trading day. Hohum really has no idea of the value of his ESO.

Fast Forward – Autumn 1992

For our two companies, it has been a long four years. A sluggish economy, high interest rates and structural adjustments relating to the NAFTA agreement have all had a depressing effect on Canadian equities. They have been very challenging years for both

Excellent Corp. and Subpar Corp. Topnotch has taken charge of his business, divesting non-core assets, reducing costs, and focusing his managers on return on capital, but the company is not yet showing consistent improvement. Hohum, despairing of Canada's weak economy and wanting to play in the big leagues, has opened a large operation in the U.S. and is losing money hand over fist. But the market is not discriminating between the two companies, and both stocks are now trading at $7 per share.

Topnotch shares the unhappiness of his fellow Excellent Corp. shareholders, since his investment has declined by $375,000 over the period since his share purchase. He feels their pain.

Hohum, on the other hand, has no downside in his ESOs. But as long as they are "out of the money" below $10, they have no value to him whatsoever. He has raised with his directors the possibility of repricing his options to reflect "current realities," as he puts it. The directors of Subpar Corp., a sympathetic bunch, agree to do so, and the shareholders, as they usually (and incredibly) do, approve the repricing.

This is an economic absurdity, of course. If a manager is held responsible for the appreciation of a stock, which is the inherent idea of using stock as a long-term incentive, then he must be responsible for the depreciation as well. So assigning a benefit like a repricing to that manager is ridiculous. Repricing options is abusive, arbitrary and offensive to any conception of common sense or fair play.

Fast Forward II – Autumn 1993

What a difference a year makes! The Canadian market has been on wheels since late 1992 and now, at the Board meetings in autumn 1993, both Excellent Corp.'s and Subpar Corp.'s share prices have rebounded to $15 in a rather indiscriminate rally.

Hohum has decided to exercise his options. He therefore buys 250,000 shares of Subpar Corp. from treasury, and immediately sells them. He has income of $2 million from his exercise and therefore owes Revenue Canada a large sum of money. (Incidentally, the options repricing of 1992 has given him a windfall profit of $750,000.) This big tax bill forces him to sell a good part of his position, and it seems odd that an incentive plan should force a manager to sell stock in his company. But why does he sell all of his stock?

Based on a sample of observations by people with experience in the corporate compensation area, option holders treat their options earnings like lottery ticket winnings. And if you offer a lottery winner the choice between cash and anything else, he will always choose cash. Unless there is a specific rule in the ESO plan requiring the employee to continue to hold a portion of the stock purchased on the exercise of options, managers will always tend to cash out.

Just check the insider trading listings in the newspaper. From *The Financial Post* of August 19, 1998: "Trizec Hahn Corporation – Andrew Blair, officer, exercised 70,000 options at $18.25 each and sold the same number of subordinate voting shares at $34 each to hold none. He still holds 260,000 options. Richard Steets, officer, exercised 30,000 options at $17.24 each and sold the same number of subordinated voting shares at $34.10 to $34.20 each to hold none. He still holds 370,000 options." [50] These gentlemen have done nothing wrong; they are acting the way option holders usually act.

The value of Hohum's option granted in 1988 is now known. A sensible accounting treatment would be to charge the $2 million gain from the options exercise to 1993 compensation expense. But that will not happen because it is not required by the CICA.

Note how Hohum was able to turn the volatility of Subpar Corp.'s stock price to his own advantage through the options repricing. Volatility to a long-term shareholder is a negative; to an option holder it is a huge advantage, and not only through repricing. The more frequently options are granted, the more useful volatility will be to the option holders, since they can influence the amount of options granted in a given year as well. Our example is deliberately oversimplified since most options plans grant options on an annual basis.

Topnotch is now sitting on an unrealized capital gain of $625,000. He is unlikely to sell his stock and pay more taxes, especially since he is able to see all the good things happening at Excellent Corp. His stock is vested so he now owns his stock outright.

Although the Board of Excellent Corp approves of the moves that Topnotch has taken, those measures are only beginning to bear fruit. The Board decides that based on his return on capital performance, Topnotch should be granted a bonus large enough to purchase 50,000 more shares of Excellent Corp. Note that because Topnotch's incentive is fully accounted for, it affects the return on capital of his company. So the more he takes, the less likely he is to make his return targets, and the less his short-term bonuses are likely to be. That is the real importance of accounting properly for these things – they tend to be self-regulating to some degree.

Hohum's directors decide to "reload the options plan" since with no options outstanding, Hohum has no incentive whatsoever. His performance is deemed satisfactory, though nobody is able to recall a specific accomplishment. They renew the previous plan at 500% of salary, which is again an issue of 250,000 shares of Subpar Corp. at $15, over 10 years, vesting in five years. Because options do not affect the cash position or reported earnings of the company, Boards of Directors do not seem to consider themselves to be spending real money. They therefore reload options plans without much thought. And Hohum has an incentive to get as large a grant as he possibly can through the options plan, since it doesn't affect his profit performance.

Fast Forward III – Autumn 1996

The Canadian stock market has continued to motor on, and business conditions have improved mightily over the last three years. Earnings have improved dramatically, and with them, returns on equity. With a bit of a following wind, Excellent Corp. has opened up a decided lead over Subpar Corp. in terms of corporate performance. While Subpar Corp.'s stock price has increased by 8% per year over the 1993-1996 period to $19, Excellent Corp.'s share price has reached $29, a 25% annual appreciation rate. Both companies now have a cash surplus.

There are three potential uses for a cash surplus. Management can invest in any business opportunities it sees that could earn a return greater than that of the company's base business. Otherwise, if no such opportunities are available, it can buyback its own stock, or return cash to shareholders through a special dividend.

Hohum has taken a lot of heat for his U.S. operation that continues to destroy shareholder value. He therefore rules out an acquisition. So his choice is between a special dividend and a share buyback. It's really no choice at all. Option holders receive no benefit whatsoever from a special dividend, since unlike shareholders, they receive no income from the option. Quite the contrary, since a dividend reduces the share price by the amount of the dividend, at least in the short term, and share price is all that option holders care about. So all the other holders of vested but unexercised options at Subpar Corp., who probably include Hohum's senior managers and even his directors, will be lobbying for a share buyback rather than a dividend. Hohum announces a share buyback.

Stock buybacks, properly used, are a tremendous way to return value to shareholders. If a company's stock is inexpensive, a share buyback can materially increase per share values, soak up excess supply of stock in the market and support share prices to some degree. But at some price, a share buyback becomes subject to the law of diminishing returns, if it is viewed as only one of several different investment alternatives for the company. Executives with a lot of stock options do not consider alternatives, however, because they have a direct interest in supporting the stock price. And since options are issued at current prices on an ongoing basis, stock buybacks by companies with large options programs tend to be done at almost any price.

Topnotch, by contrast, carefully weighs the alternatives. Excellent Corp. is now humming along at a very high rate of return on shareholders' equity, so he cannot find a direct investment that will not dilute the rate of return on his 175,000 shares of Excellent Corp. He too is faced with the choice between a share buyback and a special dividend. He will make his choice based on considerations of his shareholders. If he deems the stock price to be cheap enough, then the share buyback may increase per share values, and he will go that route. If the stock price is expensive, or if many of his shareholders hold Excellent Corp. stock for income purposes, he may elect to pay a special dividend. In all cases, he is thinking like a shareholder because he is a shareholder.

Fast Forward IV – Today

It's vesting day again for our managers. The fortunes of our two companies have diverged markedly. Excellent Corp. has gone from strength to strength, continuing to compound at 25% annual rates. The stock has now reached $45, meaning that under Topnotch's leadership, the 10-year compound return from holding the stock has been 16.2%. Topnotch's personal position is now worth almost $8 million, a very considerable fortune. Even more important, almost $6 million of that amount is unrealized capital gain. Selling the stock would be very painful for Topnotch to contemplate. It is safe to say that his interests are aligned with those of the long-term shareholders.

Hohum's shareholders and directors are becoming rebellious. His continued refusal to cut his shareholders' losses in the U.S. has led to poor performance. His stock has continued to increase at about 8% per year, despite the obvious value that he could unlock if he discontinued his U.S. adventure. The stock price has struggled up to $22 on the basis of earnings that have somehow managed to show modest growth despite the U.S. losses. Hohum exercises his options and sells all the stock at $22, leaving him a net after-tax gain of almost $2 million.

Hohum has no stake in Subpar Corp. He does have independent means as a result of the generous options program. During his decade-long tenure as CEO of Subpar Corp., the compound rate of return on the stock has been 8.2%, less even than the uninspiring 10.5% return on the TSE 300 Index over that period. Hohum, of course, has done much better than his shareholders due to his options repricing and the superb timing of his options exercise. Subpar Corp. shareholders have received very poor value for money; all they have done is to enrich a mediocrity.

The Moral of the Story

The differences between option holders and shareholder managers are:

1. The shareholder managers account fully for the expenses of their firms, so their return targets will include the full costs of their own compensation. The option holders are not accountable, in several senses of the word.

2. The shareholder managers pay their taxes up front, and are able to benefit from long-term tax-free compounding on their stock positions. The option holders pay their taxes when they exercise their options, and must usually sell at least part of their position to pay those taxes. In practice, they will usually sell the whole position.
3. Shareholder managers have the same downside as other shareholders. Option holders cannot lose money on their options. The worst they can do is not make money.
4. Option holders can reprice their options to benefit from share price volatility. Shareholders are stuck with the original deal they made when they purchased the stock.
5. Option holders can influence the timing and amount of options issued in order to benefit from share price volatility.
6. Option holders will never distribute cash through dividends if they can do a stock buyback, regardless of valuation. Shareholder managers will examine the situation based on expected returns to all shareholders.
7. The motivational aspect of options only lasts until they are exercised, after which the plan must be reloaded. Shareholder managers must stick with their stock through thick and thin. As the stock becomes more and more valuable, the motivational value increases and builds over time.
8. Option holders can, and usually do, build substantial wealth independent of the option-granting firm. Shareholder managers have their wealth in the firm, literally. Options often encourage medium-term turnover of personnel; we believe that shareholder ownership reduces turnover.
9. Shareholder managers buy their stock in the market just like other shareholders; option holders have preferential access to the corporate treasury.

In each and every case, options cause managers to behave in ways that are not aligned with the interests of long-term shareholders and that are detrimental to those interests.

Make Them Owners!

In Canada, over half of our public companies are controlled by individuals, families or other corporations. While it is difficult to portray that statistic as a big boon to the Canadian market, it has at least prevented the wholesale looting of companies by management, which has occurred in the U.S., because people with control blocks are usually careful about share issuance. For a measure of the kind of nonsense going on in America today, multiply the options grants for Topnotch and Hohum by a factor of 10 or 20.

Canadian companies have generally been less aggressive about options issuance than their U.S. counterparts. The great majority of companies here have options plans, but they rarely reserve more than 10% of the total shares outstanding for a given company. That means there are still billions of dollars worth of options outstanding and, given the very modest accomplishments of Canadian companies in the domain of return on capital, that is far more than the vast majority of these managers deserve.

What can stop the options gravy train? Well, the only reason for the existence and popularity of stock options is the fact that they are not accounted for. In the U.S., there is no reason why they should not be charged against net income as compensation expense, since even the Internal Revenue Service recognizes options as a deductible expense for tax purposes. In Canada, the taxation authorities connive at the deception involved in options issuance by not allowing a deduction for options. They just appear magically as a big increase in income to the option holder, with no recognition that the companies involved have given up something of value. And that of course gives the CICA the justification to leave options off corporate income statements on the grounds that they are avoiding an arbitrary non-cash adjustment. (This from the people who gave you deferred tax accounting.)

What are the prospects for a change in accounting for options? The outcry in America against mediocre CEOs retiring as "rich as Croesus" is growing. Many companies are experimenting with options that increase in price over time, or are indexed to the S&P 500. But those experiments are just window dressing. Ultimately, shareholders in the world's most successful and best-regulated stock market will insist on proper disclosure. Winston Churchill once said that the American people could always be relied upon to do the right thing, after exhausting all possible alternatives. He might have added that once the Americans do the right thing, the Canadians will then follow their lead.

We have already seen the tendency when stock prices are weak for managers to try to reprice their options. We predict that when the markets soften, there will be a rash of repricing proposals from managers whose options are only meaningful when they are in the money. Shareholders should reject any and all such attempts, and try to get managers and Boards of Directors back to the drawing board to redesign their long-term incentive systems.

Options do not do what they were intended to do, which is to align the interests of management and shareholders. If the fortunes from options programs are earned, they are earned at other shareholders' expense. We believe that corporate Boards of Directors should put a sunset clause on all existing options plans – except those associated with highly leveraged or startup situations – and replace them with systems of employee ownership based on share purchase. Don't give your managers lottery tickets – make them owners!

Author: **Richard Rooney, President and Chief Investment Officer**

February 1999

We're Mad as Hell

Frustrated by the deteriorating reputation of the Canadian financial system in the aftermath of several perfectly avoidable scandals, we let loose a Philippic against Canadian investors, auditors, regulators and exchanges in this issue of The View from Burgundy. *Investor behaviour has not changed since then, and may never, but there have been changes in regulation of auditors, there has been a major consolidation of Canadian exchanges, and securities regulators have moved a long way down the path to standardized regulation, always subject to Quebec's desire for autonomy and the West's fear of Ontarian hegemony.*

Richard Rooney, 2007

In the 1976 film *Network*, Albert Finney gave a riveting performance as a TV anchorman who blew a gasket and began to deliver angry tirades on his nightly news show. His culminating line, if you remember, was, "I'm as mad as hell, and I'm not going to take it anymore!" [51]

We know how he felt.

The last two years have seen a series of embarrassments and disasters in the Canadian capital markets that have turned us into international laughing stocks. Bre-X, YBM Magnex, Philip Services and Livent all have been black eyes for Canada. In this issue of *The View*, we will take a look at each of these situations, and try to extract lessons from them. We believe that it is important that responsible people intervene to stop the drift and the ineptitude that afflict Canadian markets at every level. Canada is no longer comfortably mediocre in this field as we are in so many others; we are a good deal worse than that. We have four main contentions:

1. Canadian investors are not doing their jobs.
2. Canadian auditors are not tough enough in demanding transparent accounting.

3. Canadian regulators cannot do their jobs due to the Canadian market's ridiculous Balkanization.
4. Canadian exchanges are too busy competing with each other to serve the public interest.

Investors Are Not Doing Their Jobs

One of the most pathetic sights in the capital markets are professional investors blaming their own mistakes on brokers and company managements. Elementary precautions could have prevented involvement in situations like Bre-X, YBM Magnex, Philip and Livent. What precautions? Well, when in doubt, do what the winners do:

> Before buying a stock, I like to be able to give a two-minute monologue that covers the reasons I'm interested in it, what has to happen for the company to succeed, and the pitfalls that stand in its path. The two-minute monologue can be muttered under your breath or repeated out loud to colleagues who happen to be standing within earshot. Once you're able to tell the story of a stock to your family, your friends, or the dog… so that even a child could understand it, then you have a proper grasp of the situation.[52]

Let's look at what such a two-minute monologue would have looked like for each of our situations at the height of its popularity. The date in brackets following each monologue is the date at which the monologue would have been written, usually a date close to the peak price of the stock.

1. Bre-X is a gold mining exploration company, listed on the Alberta Stock Exchange and based in Calgary, Alberta. It owns a concession at Busang in Indonesia, which management claims is one of the largest and richest bodies of gold ore in the history of the world. No conclusive assay results are available. The management consists of two mining people – neither of whom has any record of significant achievement in the industry – and a former retail stockbroker. None of the key people have any management experience. In order for the company to succeed, assays must support management contentions, and the top management of Bre-X must be able to run a huge project in a corrupt foreign country. [late 1996]

There is much to be learned about investing from the Bre-X story. Anyone who tells you that Bre-X was a satanically clever, brilliantly orchestrated fraud perpetrated by criminal masterminds was obviously long the stock. It was, in fact, a simple drill-core salting, which, if not the oldest trick in the book, is certainly somewhere in Chapter One. The insiders were a trio of losers with no track record and no management experience. This was the pre-eminent example of greater fool theory that we have ever seen.

All businesses are people "businesses" and people are the primary asset of any company. Who they are and what they have done are the starting points for any company analysis. A cursory look at the background of the people connected with Bre-X would have been enough to scare off most thinking people.

For financial analysts, there are few lessons to be learned from Bre-X, since the company never had more than $2-3 million in revenues. That means that those who purchased the stock at its peak were paying 2,000 times revenues, a level usually reserved for Internet stocks. There was no financial basis for an investment in Bre-X.

Finally, perhaps a good basic safeguard would be to buy only companies where you are sure the business truly exists.

From its peak value in mid-1996 to its delisting in early 1997, Bre-X represented the erosion of $6 billion of market capitalization. An equivalent investment would have been Power Corp., Canadian National Railway, Potash Corp, Loblaw or BC Tel.

2. YBM Magnex has its headquarters near Philadelphia. The company was originally listed on the Alberta Stock Exchange. Most of its operations are in Hungary. The Hungarian operations are owned through a holding company in the Cayman Islands. Half of the sales are to Russia and the Ukraine, which is where most of the senior managers come from. Apparently, demand for magnets is very strong in the former Soviet Union, despite a nine-year long collapse in industrial production. The auditors are Parente, Randolph, Orlando, Carey and Associates. There is no revenue recognition note in the financial statements. The company has indicated that since it never intends to repatriate the cash it earns from its operations, it is highly unlikely to pay income taxes in North America. In order for the company to succeed, its markets must exist, its cash flow must be real, and its management must be honest. [late 1997]

The organization of this company is very complex. Ultimately, Deloitte and Touche, who replaced the small auditing firm mentioned above, refused to issue an opinion on YBM because they found it impossible to untangle the flow of cash through the company accounts from sale of products to the company's bank accounts. That does not trouble us as much as the possibility that no one asked them to explain something as prosaic as the description of a typical transaction for the company. Such a question is absolutely basic to any financial analysis. And, of course, it is a pretty strange "investment" that will never return a dime of cash to shareholders because of tax reasons.

Another interesting question is why a company based in the U.S., with no apparent connection to Canada, finds it necessary to seek a listing here. The usual reason for this occurrence is that the company is unable to list in the U.S. and is seeking the lowest possible level of scrutiny of their business. And in Alberta, they certainly found that.

Concerns about the business practices of Russia and the Ukraine aside, it is highly unlikely that anyone who invested in YBM actually had knowledge of the track records of any of the senior managers. That is a huge omission for any investor.

We are, frankly, not all that familiar with the ins and outs of the YBM story, and we don't really care all that much. Those who were burned, unfortunately, deserved to get burned. A stock like this has disaster written all over it.

From its peak value to its delisting, YBM represented the loss of almost $900 million in market capitalization. Similar-sized investments were Metro-Richelieu, Cambridge Shopping Centres, Empire Company and Celanese Canada.

3. Philip Services is a provider of environmental services to various industries. The company has grown aggressively by acquisition over the past four years. Over that period, sales have grown at a compound rate of 91%, net income at a rate of 44% and earnings per share at a compound 26%. Nevertheless, the return on shareholders' equity in most years was only about 8%, and never over 11%. During 1996 and early 1997, the company made 10 acquisitions and two divestitures, a rate of almost one transaction per month. Acquisitions were the largest of the company's investing activities, with almost $270 million spent in the years 1994 to 1996. The other major areas of spending were inventories and receivables, where almost $300 million was spent in the past three years. The company has been public for several years. The President, Mr. Allen Fracassi, has a tendency to go wing-ding whenever a question about Philip is addressed to him in a tone that is anything less than fawning. The company has been known to threaten to sue analysts who have raised questions about their accounting. In order for the company to succeed, management must be able to integrate acquisitions into its strategy, ensure that controls are adequate and improve working capital management. [mid 1997]

This situation differs qualitatively from our first two examples in that it was a seasoned issue rather than a new listing. As well, the company was apparently victimized by an internal fraud without the participation of all its top management. But there were warning signs that Philip was not a good investment. First of all, frequent acquisitions are not a good sign. Anyone who has lived through a merger or acquisition can tell you that they are profoundly disruptive experiences. On average, close to two-thirds of all acquisitions do not add value for shareholders of the acquiring company. Often they subtract value, due to the management time that they devour. The Fracassis were ambitious, driven people, and it seems obvious that they overextended themselves.

Second, the ongoing investment in non-cash working capital, well above the levels apparently necessary to sustain sales growth, should have been a warning sign. Working capital management is an underestimated skill, which is part and parcel of a company's entire capital allocation strategy. The ballooning levels of inventories should have been a warning sign of inadequate controls, even if a large proportion of their increase had not later proven to be fraudulent.

Speaking of capital allocation, the gigantic increase in sales accompanied by a much more modest increase in earnings and earnings per share indicates that the company defined growth more as growth in sales and assets than as growth in shareholder value. Another indication of this is that return on shareholders' equity was virtually flat between 8% and 10% for the years 1993 to 1996. To us, high acquisition activity and low returns on equity are indicative of high purchase prices and looming problems. (Just ask shareholders of Loewen Group about that.) All of the above analysis uses the unrestated numbers from the 1996 annual report, before the discovery of the fraud in early 1998 that led to huge write-offs.

The issue of management's touchiness and aggressive treatment of perceived enemies is admittedly a rather subjective matter. But it is usually a sign of a nasty corporate culture, and reports of browbeating of Philip employees, especially accounting staff, would tend to reinforce that impression. Companies that sue analysts over accounting disagreements usually claim that the analyst simply did not understand the company's treatment, and that is not infrequently the case. But why was the treatment so difficult to understand in the first place? Companies must learn that they have a vested interest in transparency and simplicity. Investors must learn that if a company doesn't tell you what you need to know in a simple, straightforward manner, they probably don't want to tell you at all.

From the peak price of $27.80 in autumn of 1997, Philip has declined to its current status of a penny stock. The loss of value has been enormous, well in excess of $2 billion. The same investment could have bought Trimark, Fairfax Financial, Trans Alta Utilities or Canwest Global Communications.

4. Livent is the vehicle of Mr. Garth Drabinsky. Mr. Drabinsky was previously the CEO of Cineplex Odeon Corporation, which expanded rapidly in the 1980s and eventually floundered under a debt burden too large to be supported by the actual cash flows of the company. Livent has tapped into a trend towards lavish live musicals in the early 1990s. It has reported consistent profits since 1992. The reported cash flows are more than offset by capitalization of costs on the balance sheet, which annually exceed reported profits by 300-500%. The company has been increasing its exposure to large theatre projects in Toronto, Chicago and New York, with a corollary increase in fixed assets on the balance sheet. In fact, preproduction costs and fixed assets account for over two-thirds of the total assets of the company. The company believes that each successful

musical it produces will have multi-year earning power, so preproduction costs are set aside and amortized against this presumed stream of income. In order for the company to succeed, the future cash flows generated by Livent's musicals must not fall short of the amortization provided against them, and virtually all of the programs the company produces must succeed at least modestly. [early 1997]

Well, there were certainly a few straws in the wind on this one. Mr. Drabinsky has been one of Canada's more flamboyant businessmen (not a crowded field, admittedly) since he first came on the scene in the early 1980s. There are a lot of good things about him – he thinks big, he is ambitious and he makes things happen. But Mr. Drabinsky is in show business. His companies appear to be run more for his personal satisfaction and the applause of the entertainment industry than for shareholder returns. And in the area of personal diplomacy, he makes Allen Fracassi look like Prince Talleyrand. There was no excuse for investors to be unacquainted with Mr. Drabinsky's track record and management style.

The accounting used by Livent was in accordance with Generally Accepted Accounting Principles (GAAP) and the financial statements received a clean opinion from Deloitte and Touche. Nonetheless, a cursory examination of the reported financial results shows that the company was never cash flow positive in any quarter during its period as a public company. And the increasing investment in fixed assets is a danger sign for any business, since capital intensity tends to detract from shareholder returns.

We make no comments about the case that the Securities and Exchange Commission has launched against Messrs. Drabinsky and Gottlieb, since there is a presumption of innocence. We only point out that even if we accept that the accounting was according to GAAP, any seasoned analyst could have satisfied himself that Livent was a risky investment based on the excess of capitalized costs over apparent cash flows.

The erosion of market value from Livent has been about $300 million since its peak, the equivalent of the capitalization of Astral Communications, Uni-Select, Moffat or TVA Group.

So the price of our four disasters has been over $9 billion, a pretty steep tax on greed and incompetence.

Auditors Must Get Back to Basics

In the distant past, there was a basic accounting principle called the conservatism principle: anticipate no profits; provide for all losses. It was a wise principle for a profession that deals in estimates and allocations and must be forever on the lookout for fraud, defalcation and simple exaggeration of results. But in the 1970s, when conservatism had a bad ring to it, accountants began to abandon conservatism as a principle in favour of ideas like "matching of costs and revenues." It has proven to be a slippery slope.

The old emphasis on conservatism tended to minimize cost accruals by encouraging expensing rather than capitalization. It recognized the inherently uncertain nature of future cash flows and permitted a minimum of costs to be deferred against such streams of income. Incidentally, by expensing more outlays in the period in which they were undertaken, the resulting income statement demonstrated some relationship between accounting earnings and cash flows.

The New Age accounting that is now in vogue has reduced that connection. Essentially, in a lot of businesses, the relationship between cash flow and earnings is tenuous at best. Take Livent, for example. The company reported accounting profits every year from 1992 to 1996. The profits were never more than $12 million, but at the same time, the company was deferring $30-50 million per year in preproduction costs. We have already indicated that this treatment was in accordance with GAAP. Our only point is that a more conservative treatment would have given a truer picture of Livent's position to its investors. A real statement of cash flows where the top line was "Cash Received from Customers" and the bottom line was "Cash in the Bank" would be the best way to ensure that even the most story-prone investors are unable to deceive themselves about a company's liquidity.

The Canadian accounting profession could require such a statement if it wished. It is a little known fact that the *Canadian Institute of Chartered Accountants (CICA) Handbook*, the bible of the accounting profession, has the force of law for those sections of it that are in italics. This is because Canadian corporate laws specifically mention these sections in statute. But the CICA has been very loath to use these great powers. There are two reasons for this: first, the influence of the U.S. Financial Accounting Standards Board (FASB), and second, the tyranny of the financial statement "preparers."

The first problem is self-explanatory. In an economy as linked to the U.S. economy as Canada's, it would be unnecessarily burdensome to strike out into too many new directions for Canadian GAAP. Unfortunately, however, the CICA too often just follows along after the FASB's recommendations, and is often years behind. Comparing differences between U.S. and Canadian GAAP shows Canadian GAAP to be consistently both less conservative and less informative.

The dominance of the financial statement preparers requires a little more explanation. The CICA divides its constituencies into two segments: financial statement preparers and financial statement users. The preparers are the companies that must produce financial statements for regulatory or other purposes. The users are the financial analysts, regulators, bankers and others who read the statements and interpret them for business purposes.

Preparers have always tried to minimize disclosure and changes in accounting treatments, for reasons of secrecy and lower costs. They are a potent lobby group since they must execute all changes required by the CICA. At any meeting called to discuss accounting changes, the preparer groups will be well represented and vociferous in their opinions, usually in opposition to change, especially if the change leads to more disclosure. It is also true that a very large proportion of the CICA membership have careers in "preparer" jobs, like Controller and Vice President Finance.

Users, by contrast, are conspicuous by their absence from such controversies. Financial analysts in particular are reluctant to indulge in controversies about accounting, possibly because they would be tacitly admitting that they don't know absolutely everything about the companies they follow, and also because they often have very sketchy accounting knowledge. In fact, accounting matters. It is the language of business and the clearer and more reliable it is, the more useful it is.

More rigour, please, ladies and gentlemen of the accounting profession.

Too Many Regulators, Not Enough Regulation

Some free market ideologues would have us believe that regulation of all kinds is evil, and that the world would be a better place if markets were allowed to operate freely – in financial services as in everything. Tell it to the Russians. In the case of stock markets and financial systems, intelligent regulation is essential. The financial sector, with its vast amounts of the public's money sloshing around, attracts crooks like no other area. Stern and consistent regulation is necessary to protect the public and maintain its confidence in the country's financial system.

Canada's current regulatory regime is execrable. Ten provinces share the responsibility for regulating securities markets with five stock exchanges and the Investment Dealers Association, in a world where national borders, let alone provincial ones, are increasingly irrelevant. Penalties for violations of securities laws – which are rare as hens' teeth in any event – are applied on a province-by-province basis, meaning that scoundrels can always find a new playground. The money that is used to support small, inefficient and ineffective provincial securities commissions could be much better spent in ensuring that the public is not defrauded and bilked by any of the legions of flim-flammers who are attracted to any financial market, but especially a badly-regulated one like Canada's. The only law obeyed in Canada's capital markets on a national basis is Gresham's Law, as provincial regulators and stock exchanges indulge in "one-downmanship" and take their standards to the lowest common denominator.

There have been recent reports that the provincial securities regulators have agreed on a "virtual" national securities agency, to be called the Canadian Securities Regulatory System (CSRS). They will pool their scant resources to try to eliminate some of the waste and inefficiency that make the current system so burdensome to the law-abiders and so helpful to the others. More money would be available for such things as compliance and enforcement, and some standardization would be possible for prospectus filings. It might be progress compared to the current system, but it would still be less effective than a full national securities commission. The main reason for the "virtual" structure appears to be that Alberta fears the domination of Ontario in the securities field, and petty interprovincial rivalries are a poor basis for joint action. We doubt if the proposed CSRS will get us out of the bush leagues anytime soon.

Too Many Markets

The existence of five stock exchanges in Canada is a disservice to the public. Competition for listings means that there is a race for the bottom in listings standards. Both YBM and Bre-X took the route of an initial public offering on the Alberta Stock Exchange – where only your imagination restricts what you can say in a prospectus – to a Toronto Stock Exchange listing when the market capitalization and trading volumes became substantial. So great is the pressure on the Toronto Exchange to list "winners" that neither of these scams had to file a listing prospectus with the TSE. They came in through a loophole allowing the TSE to list any stock that has been previously listed on another Canadian exchange. In order to repair its badly tarnished credibility, the TSE should require that henceforth any company listed on Alberta or Vancouver that seeks a listing on the TSE must go through full prospectus disclosure.

The so-called venture capital markets in Calgary and Vancouver must be properly regulated in order to protect the public. Perhaps, as a first step, some purveyors of AIDS, common-cold and baldness cures could be sent to the crowbar hotel pour encourager les autres. The VSE has promised to clean up its act more often than Bill Clinton, and with comparable results.

But it all goes together – stock exchanges are lax because regulation is inconsistent and inefficient.

Lessons Learned – Analysts and Investors

So what lessons can we as analysts and investors draw from these distressing examples? We think there are four.

First, people matter. Top management is key. Their background and accomplishments, goals and methods are fundamental to our assessment of a company. The kind of managers we like are ones who are dedicated to their businesses, but able to keep themselves in perspective – and their egos under control. Capitalism seems to punish hubris in a chief executive.

Second, simplicity matters. The organization should be easy to understand and the transaction flow should be as well. It should be easy to identify customers and market share, and to explain what the company does for its customers. Excessive complexity, even in pursuit of reduced taxes, is a warning sign. A good way to ensure that you understand a company is to use a Peter Lynch monologue about it.

Third, transparency matters. It is important that we as analysts are able to look through the financial reports of a company and identify its financial model, and be able to see where the cash goes and why. Pages and pages of notes to the financial statements always mean trouble for the analyst, and usually for the investor as well.

Fourth, capital allocation matters. What are the company's criteria for spending your – the shareholder's – money? Are they return-oriented or only growth-oriented? Anybody can grow a company's sales and assets, especially during a bull market. But attaining a high and consistent return on the shareholder's funds requires discipline, teamwork and focus.

Lessons Learned – Auditors

Auditors, we feel, should take the lessons of Livent, and to a lesser degree of Philip, to heart. Where there is fraud and collusion, as in Philip's case, it is difficult to catch the perpetrators quickly. Nevertheless, a rediscovery of the conservatism principle would make balance sheet values "harder," prevent aggressive accruals and improve the quality of earnings reports. A separate statement of cash flows, in addition to the current statement of changes in financial position, would help to alert users of financial statements to the liquidity of the companies whose financial statements they are examining. The CICA should mandate the preparation and disclosure of a true statement of cash flows for all public companies.

Frankly, if the CICA is unwilling or unable to act on these matters of pressing investor concern, Canadian investors might be better served by the wholesale application of U.S. GAAP. That would be a sad commentary on the Canadian accounting profession, and further depressing evidence of Canada's colonial mentality.

Lessons Learned – Regulators

A national securities commission is by far the best way to go. It is also, in the Canadian political context, probably an impossible dream. Quebec has not been in the habit recently of releasing any areas of control to the federal level, and Alberta's and British Columbia's fears of Ontarian hegemony in securities regulation (despite the smaller markets' lack of resources to do the job) has scuppered any recent attempts to centralize Canadian regulation.

We should point out that the problems with the Canadian regulatory system are structural in nature, and our remarks are not aimed at the many hard-working and well-meaning individuals who work for provincial securities regulators. We have had some exceptional people working at securities commissions in Canada, but they are usually people who are not career regulators. Often, they are fast-track lawyers, joining the securities commissions almost on a pro bono basis. What is needed is a seamless, national, full-time, fully funded, tough and consistent regulator for the securities industry, someone to "kick butt and take names" in the memorable American phrase. If the proposed Canadian Securities Regulatory System is able to do the job, we will be the first to give three cheers and congratulate Canada's provinces. But we hope that we can be forgiven for a degree of skepticism.

Lessons Learned – Stock Exchanges

Both Bre-X and YBM show that haste makes waste in listing procedures. Alberta claims that its status as a "venture market" means that companies whose businesses are little more than a gleam in someone's eye should be made available to the public through a public listing. We suppose that it is possible for reasonable people to disagree on the issue, although the U.S. has no such markets and the entrepreneurial spirit does not appear to have suffered there. But what is beyond question is that the Toronto Stock Exchange should not accept a stock for listing solely on the basis that it is listed on another Canadian exchange, if that exchange is Alberta or Vancouver.

Prospectuses are wonderful things. They are far from perfect, and are after all sales documents, but a well-prepared and current prospectus is the only resource of the investor in Initial Public Offerings. That is why we don't often invest in IPOs: the investor is at the mercy of the company managements and corporate financiers who prepare the document.

The Toronto Stock Exchange has everything to gain in terms of credibility and investor confidence if it shuts these loopholes and requires prospectuses for all listings, except where the company is listed on a stock exchange with high standards, like Montreal (usually) or New York.

Conclusion

If these lessons are applied by Canadian investors, auditors, regulators and stock exchanges, those of us who have suffered from our country's loss of reputation in 1997-1998 may be able to hold our heads up among our international peers, and our country will be able to start realizing its full potential. It's time for the Canadian capital markets to grow up.

Author: **Richard Rooney, President and Chief Investment Officer**

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Unforced Errors

In the aftermath of our last *View from Burgundy,* two things became obvious to us. One is that our readers are ardent cinema fans, since our initial lapse in casting Albert Finney instead of Peter Finch as the crazed anchorman in *Network* was caught immediately and corrected more times than we can count, by email, fax and phone. The second is that some people thought we were holier than thou in scolding Canadian investors about four serious investment lapses, none of which we had invested our clients' money in. Did we never err ourselves?

Oh, that we could answer no! But, unfortunately, we have made some very educational blunders in the last few years. In this issue of *The View*, we will review two of those mistakes and draw, we hope, appropriate morals from the stories.

Goldfarb Corporation

The story of this company is really extraordinary. It originated as Goldfarb Consultants, a market research consultancy founded by Martin Goldfarb in the 1960s. The company developed a fine list of clients, and a particularly close relationship with the Ford Motor Company, which helped Goldfarb to expand into foreign markets in the 1980s and 1990s. Mr. Goldfarb did a good job of building this business. Market research consultancy firms have many of the characteristics we look for in a business: low levels of capital deployment, high returns on capital employed, strong cash flows and significant intellectual property holdings. Goldfarb Corporation went public in 1988, but because it was a microcap with only three million shares outstanding, the stock attracted little attention and languished in the bear market of 1990-1991. In mid-1992, the stock was selling at only about $2 per share, less than the earnings of $2.16 that it reported just two years later in 1994! It was truly one of the very best value buys in the market at that time. Before the end of 1993, the stock had appreciated by 1,000%.

Goldfarb Corporation always had one peculiarity – Martin Goldfarb's remuneration. While his $1.2 million annual paycheque was perhaps not unusual in a private research firm, it was rather anomalous in the world of small public companies. And it was all salary, no bonus. Mr. Goldfarb, whose talents as a market researcher were undoubted, also fancied himself a corporate financier. He had an "override" provision written into his corporate compensation policies to the effect that he personally would collect up to 7.5% of pre-tax, pre-bonus profits of the company. Note that it was not just operating profits, which would have at least aligned his interests to some degree with those of his shareholders. There was a definite incentive, under this type of structure, to engage in deals to increase the pre-tax income of the company from non-operating sources. Note also that no mention is made of pre-tax losses. And since Goldfarb is structured with the ever-popular dual class share structure, and Mr. Goldfarb and his family own the multi-voting shares, he had a free hand to compensate himself as he saw fit.

Mr. Goldfarb's major effort in the field of corporate finance was to take a position in then-private Speedy Muffler King, the franchise auto repair chain. Unfortunately, after an early success with the initial public offering, Mr. Goldfarb held onto his position too long and was stuck with a deteriorating situation. His response was to average down. His method, unfortunately for Goldfarb Corporation shareholders, was to pay for Speedy shares with Goldfarb shares. After a series of share exchanges, Mr. Goldfarb had succeeded in taking a company that had three million shares outstanding and 1.2 shares of Speedy per Goldfarb share, and turning it into a company with six million shares outstanding, with 1.1 shares of Speedy per Goldfarb share. The practical effect was to dilute by 50% the Goldfarb shareholder's ownership of the market research business, which was the main reason to own this stock. So when Speedy expanded too rapidly and blew up, Goldfarb Corporation's fortunes were tied closely to a deteriorating holding and Goldfarb blew up as well. The stock performed very poorly indeed, declining to only \$6.40 in mid-1998 from a high of \$22 in 1994. The stock market averages rose by over 60% in the same period, and good businesses like the market research business would have done substantially better than that. So Mr. Goldfarb's corporate finance activities in this later period cost his shareholders at least \$15 per share, and at least \$25 million in market capitalization. His 7.5% share of the value destroyed was between \$1.8 million and \$3.2 million, at a conservative reckoning. In 1997, Goldfarb Corporation reported a pre-tax loss of over \$80 million, due to huge write-offs of assets. Mr. Goldfarb's 7.5% share of the loss exceeded \$6 million, but no payment to the company was forthcoming.

When he sold his market research business in 1998, Mr. Goldfarb awarded himself 7.5% of the value he had "created" through the deal, or about \$2.2 million. There was no consideration of the substantial losses suffered by shareholders on the previous deals. So Mr. Goldfarb was apparently responsible for the good things that happened to his company, but not for the bad. If only we could identify the culprits for those bad decisions!

Goldfarb Corporation's story illustrates several vital lessons for investors. These lessons are: (i) the importance of equal treatment of shareholders; (ii) the importance of compensation systems as reflective of the core values of a corporation; and (iii) the importance of focus and good capital allocation by top management.

The structure of a company often tells potential investors a great deal about the way they will be regarded by management. The use of limited voting shares is a signal that the company welcomes your money, but not your opinions. Often, it is a sign that the management really wants to run the business like a private company. The goal of public company management is to maximize wealth for all shareholders by making prudent, high-return capital allocation decisions in order to grow the business and its stock price. Private companies, of course, can be managed with a wide variety of goals. In the case of Goldfarb, the existence of restricted voting shares and the override where the CEO took a potentially large piece of the upside for himself indicated that the company was not being managed in the interests of all shareholders.

We pointed out that Goldfarb Corporation's compensation arrangements were peculiar. What do they tell us about the core values of the company? The obvious conclusion to be drawn about Goldfarb Corporation is that it is a one-man band, and that its primary goal is the enrichment of Martin Goldfarb. In his latest proxy circular, Mr. Goldfarb maintained his 7.5% override, but cut his salary to a mere $120,000. Any thought we may have had that matters were improving was dispelled by the grant of 105,000 share options by Mr. Goldfarb to himself at very attractive prices. Options were hitherto one type of compensation concerning which Mr. Goldfarb had shown some restraint, awarding himself one grant of 75,000 options in 1996. Also keeping the wolf from the Goldfarbian door are the director's and management fees of about $180,000 that he collects annually from Speedy Muffler King, and the $1 million salary he continues to collect from the consultancy business until 2001. It is interesting that when he sold that business, he arranged for a continuing personal subsidy from the consultancy business rather than increasing the selling price, which would have benefited all shareholders. And in the latest quarter, he awarded himself another multi-million dollar payday at shareholders' expense. In this case, he rewarded himself for selling assets that were substantially written down in 1997.

Managements with unfettered control over their own compensation packages are like Oscar Wilde: they can resist anything but temptation. Mr. Goldfarb set up an irresistible temptation for himself when he put that override in his corporate articles, to ignore value subtracted and reward himself for value "created." And, of course, Mr. Goldfarb's predisposition to resist temptation may be open to question.

Capital allocation, as usual, is the most important issue for investors. Goldfarb Consultants was a terrific business, one of the best we have seen. It was the major reason we bought the stock. Had Mr. Goldfarb stuck to his knitting, and put his very considerable talents to work growing that particular business, he might very well be a wealthier man than he is today, and the tone and content of this issue of *The View* might be very different. As it was, even with Mr. Goldfarb distracted by his adventures in corporate finance, the business showed an ability to grow at double-digit rates in both revenues and earnings over a very long period of time. But Mr. Goldfarb succumbed to the temptation of doing deals.

Why is deal-making such a huge attraction for so many corporate managements? It is because the system rewards it. An acquisition is a good way to get your name in the paper, and to make you feel like you are at the centre of the action. The potential for more deals and more equity and bond issues means that investment bankers and analysts will treat you like royalty. So more money managers will become aware of your "story" and your float and market capitalization will increase, though not necessarily your share price. It is so much more psycho-socially rewarding than tending to your core business, making little tuck-under acquisitions and quietly maximizing profits.

We do not condemn an acquisition strategy root and branch. A lot of good companies have been built through acquisition strategies. If the businesses are complementary, clearly understood by management and bought at good prices, then the strategy can work very well. We simply believe that a company that has a good basic business should stick with it through thick and thin, and resist the temptation to make a big splash in unrelated businesses.

In Goldfarb Corporation's case, Mr. Goldfarb got lucky with his initial Speedy investment, and made a lot of money in the short term. The stock market tends to do this to people – it rewards you richly for doing something you shouldn't, and sets you up for a fall. The vast majority of Goldfarb Corporation's score on Speedy was later given back through a very ill-advised "averaging-down" strategy, which badly diluted Goldfarb Corporation shareholders.

Which brings us to another capital allocation issue – the use of common stock as currency. This tendency has reached its reductio ad absurdum in the technology area, where valuations are meaningless and gigantic nominal dollar value paper trades are commonplace. This is all rather harmless as long as people don't get the impression that they are engaging in real transactions. In the case of Goldfarb, however, real harm was done to the holders of Goldfarb Corporation shares by the use of its equity as currency. These shares were fractions of the market research business, and they were traded on a disadvantageous basis for shares in Speedy Muffler King, a much poorer business. Buffett calls this process "watering the weeds and digging up the flowers." A really superior management treats its common shares as the most expensive form of financing, not the cheapest, and issues its shares sparingly.

So our two-minute monologue on Goldfarb ignored one vital factor – the reliability of management and the extent to which their interests were aligned with ours. While we haven't lost money on this stock, the opportunity cost of holding it instead of almost any other company in our portfolio has been large. In compensation ideas, business strategy and treatment of minority shareholders, Mr. Goldfarb's actions have been the opposite of everything we stand for. As part owners of his company, we believe that he should mend his ways.

Future Shop

Future Shop is a well-known Canadian retailer with a dominant market share in the computer and home electronics business. It has grown from modest origins in the Lower Mainland of British Columbia to a familiar presence in malls and main streets across Canada.

This company competes in a brutal business. The prices of the goods in inventory fall precipitously on an ongoing basis. Obsolescence is rapid and inevitable, and renders unsold goods almost valueless. Little wonder, then, that most of Future Shop's Canadian competitors of several years ago have either gone bankrupt (like Majestic Electronics and Adventure Electronics) or abandoned the segment (like the department stores). No competitor comes remotely close to Future Shop's dominance of its segment.

What accounts for Future Shop's success in Canada? Well, it is a pretty good merchandiser. And it has structured its supplier arrangements so that the obsolescence risk is controlled. But the biggest source of profits for the company has always been the extended warranties sold with its products. Anyone who purchases an appliance or computer at Future Shop is subjected to a very hard sell on the virtues of an extended warranty by the salesperson. A high percentage of shoppers buy one, since these are very complex products that most buyers do not understand. But in practice, the claims against these warranties are low. So Future Shop is a little like a property and casualty insurance company with a very low claims ratio. And that is a very good business to be in.

The story of Future Shop differs from that of Goldfarb in almost every way. Future Shop never lost its business focus; it never indulged in excessive compensation practices;

the majority owner suffered right along with the rest of us over the past three years in terms of his stock's underperformance (although in his case the pain was self-inflicted); and the company only issued shares when it had to. Yet the result has been the same: essentially the stock has done nothing for three years during a great bull market. And it can clearly be demonstrated that one specific initiative cost shareholders of Future Shop millions of dollars over that time period. The problem is a familiar one to investors in Canadian retail stocks: Future Shop decided to expand into the U.S.

It is commonly observed that Canadian retailers have a tendency to destroy shareholder wealth when they venture into the U.S. The list of casualties is familiar: Dylex, Canadian Tire, Imasco, Northwest Company. The only exception we can think of is Suzy Shier, whose big score on Wet Seal is perhaps the best-kept secret in Canada. All the others wasted huge amounts of shareholders' capital. All entered the U.S. market assuming that the previous adventurers simply didn't know what they were doing. All were correct, but failed to draw the obvious inference.

We once heard an American retailing executive give the following definition of retailing strategy in the U.S.: "First, you think of the very most irresponsible, destabilizing and damaging thing your competitors could do to you; then, you do it to them first." Into this environment, red in tooth and claw, the kinder, gentler Canadians entered like Daniel into the lion's den – but without divine protection.

Future Shop's decision to enter the U.S. illustrates one of Buffett's major points about business. The company left its circle of competence when it left Canada. It left behind its competitive advantages as well. The U.S. market is served by several large national electronics retailers, such as Best Buy, Circuit City and Good Guys. These are immense companies, with corresponding economies of scale. There are also several large regional players. Gross margins are lower in this business in the U.S. than in Canada, and advertising costs higher, so economies of scale are even more important there than in Canada.

Future Shop initially expanded into the Pacific Northwest, where competition was not yet as fierce as in most parts of the U.S. Shareholders were warned that there would be several years of startup losses as the company built a critical mass. They weren't kidding. The U.S. operations cost Future Shop about $30 million in earnings in each of fiscal 1997 and 1998 (year ending March 31). That amounts to a startling $2.50 per share of annual earnings. With the U.S. operations consolidated, Future Shop reported marginal profits in those years, and the stock price stagnated around $11, where it has been since 1996. As a stand-alone company, Future Shop's Canadian operations would have easily supported a stock price in the $25-30 range. So in terms that we care about, namely market performance, Future Shop's foray into the U.S. was a $200 million error.

By the time Future Shop management decided to cut their losses in early 1999, the write-off of the U.S. operations essentially wiped out the book value of the company, and they were forced to issue $42 million in new common stock to recapitalize it. Insult was thus added to injury. All of a sudden, the U.S. was no longer necessary for the long-term growth of the company. Apparently, Canada now offered growth aplenty.

Predictably, Future Shop management insist that they are sadder, wiser and better merchandisers than they were before the U.S. adventure. We wish they had gone to school at their own and not their shareholders' expense. A good school might have taught them George Santayana's wise saying about those who fail to learn the lessons of history are condemned to repeat them.

In Conclusion

We wish to deal with one obvious question: Why are you still holding these stocks? In both cases, the answer is value. Goldfarb, after selling its market research business and most of Speedy Muffler King, is an unindebted company with a lot of cash and a net asset value of probably $18, trading at $11. Future Shop has demonstrated earning power of over $2 per share, and is trading at only $11. And should Circuit City ever decide to expand into Canada, they could buy the dominant market position in the whole country by buying Future Shop. So call us cockeyed optimists, but there seem to be reasons for patience. Future Shop management saw reason; so might Martin Goldfarb.

Some people work according to the old Wall Street Rule: If you don't like it, sell the stock. That is always an option, of course, but we prefer to view it as a last resort. A few years of gentle reminders can be quite effective in reminding people of their duties. Canada does not have so many good investment opportunities, after all.

Warren Buffett says that there are no called strikes in investing. You can stand at the plate forever if you wish, waiting for your pitch. We didn't do that with these investments. Clearly, there was reason not to invest in either of these situations. Future Shop management told us that they were committed to growth in the U.S., and that it would be costly. Martin Goldfarb's compensation arrangements are disclosed in his annual shareholders' circular. We ignored the warning signs, and were stuck with dud investments as a result. No one made us buy these stocks. At the risk of mixing our sports metaphors, these were unforced errors.

Author: **Richard Rooney, President and Chief Investment Officer**

October 1999

The Ham in the Sandwich

On the occasion of an address to the Financial Reporting Conference of the Canadian Institute of Chartered Accountants, our firm delivered an assessment of the position of the auditor in the late 1990s and concluded that it was acutely uncomfortable and filled with the potential for conflicts or perceived conflicts. It reads rather quaintly now that Sarbanes Oxley bulldozed managements into much more stringent (and expensive) actions than this modest series of proposals would have foreseen. Separation of audit from consulting practices followed the Enron scandal immediately. Vastly increased responsibilities for the Audit Committee also followed.

We feel that we were a useful part of this debate, and even a little ahead of our time.

Richard Rooney, 2007

Richard Rooney, CA, the President of Burgundy, gave the following speech to the Financial Reporting and Accounting Conference of the Canadian Institute of Chartered Accountants, on September 28, 1999. Mr. Rooney has been nominated to the Canadian Accounting Standards Board, where he may have the opportunity to put his money where his mouth is.

Ladies and gentlemen, you have been drawn here under false pretences. Your program agenda made reference to our firm's February publication, and implied that I would be referring to it extensively. My speech today did arise out of that publication, but it is focused on one specific area. My remarks about auditors and accountants in the February publication were rather brief and general. What I want to do today is give you a shareholder's view of the accounting profession as it appears in 1999. For those of you who can still hear the names "Bre-X" and "Livent" without nausea, and are interested in our opinions, all of our publications are available free of charge on our website at www.burgundyasset.com.

A reasonable description of my job would be "professional shareholder." What I attempt to do on an ongoing basis is value the equity of companies relative to competitors and relative to competing investments. It is a job that can be as simple or as complicated as you wish it to be. At my firm, we tend to try to keep things simple, bearing in mind the dictum that simple things are rarely easy. We look for companies that deliver high returns on shareholders' capital consistently, which are well financed and run by trustworthy and competent people. We try to find a number of these investments and then hold them for the long term.

One document is the foundation for all of our work. That document is, of course, a company's financial statement. As in most advanced capitalist economies, we can generally rely on the propriety of these statements, due to the protections afforded us by the system of external auditors and securities commissions, which has evolved over the last 70 years or so.

The accounting profession is our first line of defence against fraud and error in these statements. If it doesn't do its job, then I can't do mine. The second line of defence, the Securities Commission, is supposed to backstop the system if the auditors and accountants don't do their jobs. But it is really only expected to deal with rare and exceptional cases where the auditing and accounting professions have failed to ensure that the financial reports are presented fairly. The underlying assumption of the whole system is that the first line of defence is working.

So I was disturbed by the remarks of Arthur Levitt, the SEC chairman, in September of last year, and those of David Brown, the OSC chairman, in June and September of this year. These gentlemen paint a very grim picture indeed of the state of financial reporting and auditing in North America.

I've been giving the subject a lot of thought lately, and I've come to four conclusions. First, that the negotiating position of the external auditor has become dangerously weak, and must be reinforced through some changes in Canadian corporate governance. Second, that some of the wounds to the profession's credibility are self-inflicted. Accounting firms must end the perception of conflict of interest between audit and ancillary services offered to audit clients. Third, that managements' lack of accountability for their stock options has given them a powerful incentive to cook the books, so changes must be made in the way employee stock options are granted and accounted for. And fourth, that Canadian accounting standards must either become more rules based, or compensate for their elasticity by offering shareholders better-structured financial statements and improved disclosure.

Corporate Governance and The Auditor – Pollyanna or Frank Magazine?

I'd like to start by reading you two paragraphs. The first will outline how Canadian corporate governance is supposed to work. It is the Pollyanna view, if you like. The second is the way the system might be viewed by a jaded and cynical person who dislikes the system intensely. It's the *Frank Magazine* view.

Here's Pollyanna:

> Every year at its annual meeting, a public company's shareholders elect a slate of directors who appoint the management of the company. The shareholders also appoint the independent auditors who will attest to the fairness of the financial statements prepared by management. The auditors will ensure that the financial statements are prepared in accordance with GAAP (Generally Accepted Accounting Principles), whose standards and principles are determined by the accounting profession after due process and codified in the *CICA Handbook*. Production of the financial statements will involve a process of negotiation between the auditors and the management on a wide variety of issues. Unresolved or contentious issues between the auditors and management can be raised in front of the Audit Committee of the Board of Directors who, as the shareholders' representatives, will make whatever determinations are necessary to protect shareholders' interests.

And here's *Frank Magazine*:

> Every year at the annual meeting, the senior managers of a public company nominate a group of their friends to the Board of Directors. Providing they have not caused too much inconvenience, the auditors will be reappointed by the management as well. If the auditors have been difficult, they can be pacified by promises or threats about current or future consulting work. Management will do its level best to manipulate the financial statements to provide themselves with the best opportunity to make money from their stock option plans, whether that involves smoothing earnings to show a deceptively reliable progression, taking big bath write-downs to shore up future profit reserves, or making some "immaterial" errors on the interim report. The near-absence of firm rules in the *CICA Handbook* makes this exercise pretty easy. In the event of a fundamental disagreement over GAAP between management and auditors, the Audit Committee will listen to both sides of the question and then side with management, because the Audit Committee members have stock options, too.

Now the fact is that sometimes the Pollyanna version is pretty close to the truth, and sometimes *Frank Magazine* has the right version. Usually, the truth is somewhere in the middle. But I think it's clear that the *Frank Magazine* version is not where we want to be. And the position of the auditor and professional accountant in that reality is completely untenable.

Canada has plenty of Boards of Directors that have been appointed by management. And on such Boards, the Audit Committee can be a mere cipher. In cases like that, the auditors really serve at the discretion of the management of the company, not of the shareholders. So the negotiation process that is supposed to take place doesn't. And the auditors are left with the stark choice: sign off, or resign. It is not surprising that the latter choice is so seldom taken.

Conflict of Interest – Auditors or Consultants?

This imbalance of power would make the audit firm's position quite difficult even in the absence of other factors. But one of those factors muddies the water considerably: the provision of ancillary services to audit clients, especially general management consulting. Now I am aware that the consulting arms of the big accounting firms did not arise out of some satanic plot to undermine the legitimacy of the audit function. They arose, incrementally and naturally, out of a desire to help our audit clients. But what's that old saying? The road to hell is paved with good intentions.

Auditing and consulting are very different jobs. Auditing is a painstaking progress through the financial data towards the issuance of an opinion on the financial statements. And consulting? Well, one of my professors at the University of Toronto, John Crispo, used to say that a consultant was someone who is brought in to solve a problem and stays around to become part of it. A really good consulting project never ends. Auditing is a shareholder-focused activity; consulting is a management-focused activity. Think about it: What consultant could ever take a position that is fundamentally opposed to that of senior management? Yet an auditor must be prepared to do that at any time. If you are auditing and consulting to the same public company, it is tough to look independent. And that perception of auditor independence is vital to me as a shareholder. If the auditors are not on my side, it's a cold world out there.

Gilding the Lily – Options and Earnings Management

As if this institutional weakness and perception of conflict of interest was not enough, the managements with which auditing and accounting firms must deal are now sometimes less reasonable and less reliable as stewards of the shareholders' interests than ever before. Gilding the lily has been a natural temptation since the dawn of financial reporting. But never has the lily-gilding industry been as huge and as difficult to control as today. The main reason for this imperative to cook the books is the metastasization of the employee stock option plan. And this has been a case where the process has been aided and abetted by the accounting profession.

I'm sure that you have seen the numbers coming out of the U.S. on options grants. Managers of the 350 largest U.S. corporations realized over $1 billion in options gains in the single year 1997. Gains from vested, but unexercised options were over $7 billion at the end of that year. Over $45 billion worth of options had been issued in the five calendar years ending 1997. These companies had reserved 13.2% of their total shares outstanding for employee stock options at that time. And things have become much worse since then. This is looting on a scale unprecedented since the days of the robber barons. And because of the accounting rules, it is made to appear a victimless crime.

There is no expense charged to income for options gains. Yet, as Warren Buffett asks, if options are not compensation, what are they? And if they are compensation, why are they not accounted for? Since options have no direct effect on net income under current accounting treatments, managements can reward themselves opulently for profit achievements that do not take into account the full costs of their own compensation. It is the most intellectually dishonest accounting treatment I have ever seen.

We wrote an article in our firm's publication in August of 1998 on the subject of employee stock options. We dealt with the behavioural aspects of these plans in some detail. One issue we did not address was the role of stock options as an incentive to aggressively manage earnings. I'll make up for that now.

My thesis is simple: option holders will always make the decision most likely to positively affect the stock price right now. And the most direct influence on the stock price is the quarterly earnings report. So it follows that earnings must be managed if options gains are to be maximized. We have seen what happens to the stock prices of companies that disappoint expectations, even by a modest amount. Exceeding expectations is almost always good for the stock price. And mammoths like Dupont and GE have a major interest in showing stable, predictable earnings, with a very low standard deviation around a long-term growth rate. Their nosebleed Price-Earnings multiples depend on it. All this adds up to an irresistible temptation to manage earnings aggressively. I believe that the systematic earnings management of major U.S. corporations has given the investing public a totally unrealistic conception of the sustainability and stability of corporate earnings. This, in turn, has led to equity prices being bid up to totally unrealistic levels, with consequences that are not yet known, though somewhat predictable.

So this is the basic message: earnings management is the symptom of a major disease in the capital markets. That disease is employee stock options. Because employee stock options are inadequately disclosed and accounted for, this form of employee compensation lacks the self-correcting nature of salaries and bonuses, which impact the net income figure on which managements are usually assessed. The absence of this self-correcting mechanism leaves management with an irresistible incentive to manage earnings, overstating or understating earnings as required. The rewards for successful earnings management over a period of years can be enormous, as investors award very high multiples to companies that show reliable earnings growth. This is not a trivial issue! It is at the root of many of our problems with aggressive and inconsistent accounting treatments. And options grants are not yet out of control in Canada, as they clearly are in the U.S. Action now could help to keep us off the earnings management merry-go-round that they have been on in America for the last five years.

Stock options also tend to subvert Boards of Directors. Directors with options have their interests aligned with other holders of options, not with shareholders. And the other option holders are the managers of the enterprise. So options are a dangerous threat to director independence, especially for Audit Committee members.

The Gaps in GAAP

A situation where the auditor's negotiating position is weak, where the auditors are perceived to have conflicts of interest, and where management is working to its own wealth-creating agenda at the expense of the shareholders is not very healthy. But now let's add the last ingredient to the recipe: gross inconsistencies in accounting treatments caused by the latitudinarian approach of Canadian standards-setting.

Let me give you an example. It's not a terrible or outrageous example, just the kind of thing we run into all the time. Two weeks ago, in our morning investment meeting, we were looking at public mutual fund companies. Now, when a broker or financial planner sells a mutual fund, the mutual fund company pays him a commission. The money is paid out immediately and is deductible for tax purposes. The companies tend to capitalize the expense as a deferred sales charge, and amortize it over varying periods of time. One company, which we will call Investors Group, expenses 50% of the sales charge immediately, and the other 50% over 18 months. Another company, which we will call Trimark, capitalizes the whole thing, and expenses it over three years. Mackenzie and Dundee capitalize and expense over seven years. Dundee and Investors have the same auditor, despite being at opposite ends of the spectrum in amortization periods. Now I can't figure out why three such variant treatments are used for the same problem. It's not as if the Investors Group funds have higher turnover among unitholders than the others; on the contrary, it is about half as high. In the U.S., they'd probably have a rule for this, and the result would be comparable income statements for these four companies. In Canada, my analysts tell me that you just don't look at earnings for these companies. That is a terrible indictment of Canadian financial reporting, and one we are hearing more and more often.

Any experienced analyst will agree that there are usually no right or wrong answers in accounting, only different ways of painting the picture. But one of the most powerful tools of the shareholder in analyzing companies is comparison, and huge variations in accounting treatments like the previous examples only serve to reduce the usefulness of the net income figure by reducing comparability. To have comparability, we must have a degree of consistency.

The inconsistencies in application of GAAP are beginning to seriously annoy the regulators, and with reason. If you have read Mr. David Brown's speech to the ICAO Business Leaders Luncheon in June of this year, you will remember that he went into this problem in detail. In one case, he found the same accounting firm advocating contradictory treatments for the same transaction, for different clients. This kind of incident is gravely disquieting to me as a shareholder. And as a shareholder, I welcome the toughness and activism of the securities commissions.

Conclusion

Let me return to the four diagnoses I made at the outset of the speech.

My first contention is that the position of the external auditor versus management has become dangerously weak, and must be reinforced by changes to Canadian corporate governance.

Steps must be taken to redress the balance of power between management and auditors. All too often, our *Frank Magazine* version of corporate governance actually applies. So what are the possible remedies? Well, if you talk to any academic, they will tell you that a good way to empower yourself is to get tenure. What if auditors were appointed for periods of five, seven or ten years, rather than the traditional one year? It would certainly transfer power from managers to auditors, if the auditors' incumbency was longer than that of the average CEO.

Another way would be to require shareholder approval of firing as well as appointment of auditors. That would make a change of auditors an automatic agenda item at annual meetings. That way, the departing auditor could answer questions from shareholders, and would not just go gently into that good night. Auditors and regulators should think about mechanisms like these that involve shareholders in the process, rather than treating them as bystanders.

My second contention is that accounting firms must overcome the perception of conflict of interest between audit and ancillary services offered to audit clients.

I believe that the independence of the auditor is a vital part of the system. Some related services offered to audit clients give rise to a perception of conflict of interest. The immediate fix for this problem is disclosure; all dealings between a company and its audit firm should be disclosed in a related party transaction note, regardless of materiality. Warren Buffett says that the supreme test of the propriety of an action is if you are willing to see it reported in detail on the front page of your hometown newspaper. Let's apply that test to our profession. Longer term, I feel that auditing and consulting should be entirely separate entities.

My third conclusion is that changes should be made in the way options are granted and accounted for. Contrary to popular belief, employee stock options do not align managers' interests with shareholders. They also act as an incentive to manage earnings.

When employees exercise a stock option, they are appropriating money that has been foregone by the shareholders of the company. There should be recognition of this cost in the financial statements of Canadian public companies. Canadian managements do not yet have as massive a stake in the options system as their U.S. counterparts, so action is still possible.

Members of the Audit Committee of the Board of Directors should not be permitted to participate in employee stock options plans. Ideally, all non-employee directors should be ineligible for such plans. Stock options grants align directors' interests too directly with management, rather than with the shareholders to whom they owe their primary allegiance.

My fourth and final conclusion is that Canadian accounting standards must either become more rules-based, or compensate for their elasticity with better statement structure and improved disclosure.

If the profession wishes to make the net income calculation meaningful, then it must be prepared to make rules and enforce consistency. If it is not prepared to make rules, then it appears likely that the regulators are prepared to do so. So it is the self-regulation of the profession that is at stake in this area. Ladies and gentlemen, we need some breakthroughs in the area of standards and disclosure. Canada is not well regarded in international circles as a place to invest. And it's pretty clear to me who is going to take the blame for that.

Fortunately, I believe that there is a solution at hand that would at the same time leave the Canadian system of standard-setting philosophically unchanged, while taking Canada to the forefront of financial reporting and offering a new level of service to financial statement users. I am referring to adoption of the direct method of reporting for cash flows from operations as outlined in Financial Accounting Standard 95 (see attached Exhibit One).

The objective and easily comprehensible nature of this statement would be a huge boon to users of financial statements. Use of this statement structure might have prevented or at least mitigated some of Canada's recent embarrassing and expensive disasters. Livent, Loewen Group and YBM Magnex come to mind. The arguments against the use of this statement are not convincing, and those in favour are overwhelming. The status quo is the worst of both worlds – we get U.S.-style statements without the rules that often make them more consistent and comparable.

You will have noticed that my view of the world has been conditioned by my experiences as a shareholder. I see regulators and shareholders as people with very similar interests in the area of financial reporting. I see management as having its own agenda, often complementary to, but sometimes directly opposed to, both of these groups. And I see accountants as the ham in the sandwich – their better instincts inclined to the side of the shareholders and regulators, but their economic interests perhaps more aligned with management. That ambiguity currently threatens the credibility of the profession, and steps must be taken to address it.

We Chartered Accountants are the heirs of a proud legacy and guardians of a public trust. Unless we set our standards very high, the legacy will be dishonoured and the trust will be reposed elsewhere.

EXHIBIT ONE An Example of the Direct Method (FAS 95) Consolidated Statements of Cash Flows Years Ended December 31		
	1998 (thousands $)	**1997 (thousands $)**
Cash Flow From Operating Activities		
Cash receipts from clients	**186,064**	135,059
Cash paid to suppliers and employees	**(166,694)**	(131,071)
Distribution from equity investments	**96**	222
Interest received	**2,930**	1,721
Interest paid	**(3,221)**	(2,110)
Income taxes paid	**(7,217)**	(3,634)
Cash Flow From Operating Activities	**11,958**	187
Cash Flow From Investing Activities		
Business acquisitions, net of cash acquired	**(6,718)**	(11,827)
Net proceeds on disposition of capital assets	**85**	-
Purchase of capital assets	**(4,579)**	(2,162)
Proceeds on disposition of capital assets	**762**	85
Cash Flow From Investing Activities	**(10,450)**	(13,904)
Cash Flow From Financing Activities		
Repayment of long-term debt	**(2,998)**	(650)
Proceeds from long-term borrowings	**-**	6,294
Repurchase of shares for cancellation	**(459)**	-
Current tax benefit of financing costs	**396**	449
Proceeds from issue of share capital	**11**	14,174
Cash Flow From Financing Activities	**(3,050)**	20,267
Net increase (decrease) in cash and cash equivalents	**(1,542)**	6,550
Cash and cash equivalents, beginning of the year	**7,613**	1,063
Cash and Cash Equivalents, End of the Year	**6,071**	7,613
Cash and Cash Equivalents Consist of:		
Cash	**6,071**	16,645
Bank indebtedness	**-**	(9,032)
	6,071	7,613

Source: Burgundy Investment Team Research

Author: **Richard Rooney, President and Chief Investment Officer**

2000 – 2004

2000
Tech bubble era

2001
Terrorist attacks on U.S.; hijackers fly jetliners into New York City's Twin Towers

2002
Euro currency debuts in 13 European countries

WorldCom goes down

The Sarbanes-Oxley Act

2004
Hyper resource valuations

April 2000

Horatio's Answer

Burgundy has never experienced performance pressures like those of early 2000. The tech bubble, a compendium of everything that was wrong with the markets of the 1990s, left Burgundy vastly behind all the index averages. We were under great pressure to own technology stocks, and faced intense criticism for not doing so, and for insisting that what was happening in tech stocks was insanity. In true contrarian style, we held our first Client Day on April 5th, 2000, just three weeks after the NASDAQ Index peaked (at more than twice its level seven years later). We were lucky in that the first major break in the NASDAQ occurred just two days before this event, so criticisms were somewhat muted.

Horatio's Answer was a response to our clients who wanted to be sure that we understood technology investments and were not being "recklessly conservative" as the usage of the day had it.

Subsequent experience and returns tended to exonerate us in their eyes.

Richard Rooney, 2007

Richard Rooney, CA, CFA, the President of Burgundy, gave the following speech at Burgundy's Client Day on April 5, 2000.

There is a conversation that takes place in Act I, Scene V of Shakespeare's *Hamlet* that has been running through my mind lately. The exchange is between Horatio, an intelligent empiricist, and Hamlet, a brooding, intuitive romantic. The two have just seen Hamlet's father's ghost. Horatio, shocked and disoriented, says: "O day and night, but this is wondrous strange!" [53] Hamlet replies: "And therefore as a stranger give it welcome. There are more things in heaven and earth, Horatio, than are dreamed of in your philosophy." [54]

For the past six months, I have been playing the part of Horatio. The technology sector deserves an Academy Award for its portrayal of the ghost. And Hamlet's speech has been delivered by various money managers, brokers, economists and best-selling authors. Rather than asking me to believe in ghosts, these people tell me that the kinds of investments available in this sector are not dreamed of in my philosophy. They tell me that there will be huge returns available from technology investments, that we are at the beginning of a long boom, and that my methods of valuation are no longer relevant. And like Horatio after his brush with the ghost, I have felt sufficiently disoriented and shocked that I had no immediate reply.

We have done a great deal of soul-searching at Burgundy about our valuation techniques and the scope of our investment activities. This morning I would like to share with you the results of that soul-searching. First, we are going to look at the valuation methods Burgundy has been using. Then, we will look at an alternative valuation method that has been proposed for hyper-growth companies. After that, I would like to look at technology value investors, a breed many of you probably think is either extinct or oxymoronic. Finally, I would like to give you what I call Horatio's answer: a value investor's approach to technology.

Discounted Cash Flow – The Old Reliable

Most of you know that we use Discounted Cash Flow (DCF) analysis as our primary method of valuing stocks. I want to show you a very basic example of our approach, using a familiar subject.

CANWEST GLOBAL DISCOUNTED CASH FLOW ANALYSIS

	1999	2004	Thereafter
Cash Flow	\$132.7	\$266.9	Annuitized
Growth Rates			1999 – 2004 = 15% After 2004 = 0.5% per annum
Discount Rate			8.5%
Net Present Value		\$3.69 billion	\$25.29/share

CanWest Global is one of Canada's major broadcasters. It has grown its earnings very rapidly during the past decade. If we forecast out the earnings at a 15% rate for the next five years, annuitize them at that level for the following period, and then discount them back to the present at 8.5%, we get a value of \$25.25 for the DCF stream. Since the stock is currently trading at \$16, it is trading at only 63% of intrinsic value.

Now let's make some observations about this model. It uses a five-year time horizon, for two reasons. First, five years is usually considered the maximum period that a forecast has a reasonable chance of being approximately correct. Second, the discounting feature means that the near years are much more important than the out years in the valuations of most companies. And the higher the discount rate, the more that is true. The first five years of a discount stream capture 34% of a perpetuity discounted at 8.5%, and over 50% of a perpetuity discounted at 15%. So if you get the near years right, you're well on your way to a usable valuation.

We used to think that there were only two ways to be wrong about our models. One was using the wrong discount rate, which means overestimating or underestimating the volatility of the cash flows. The other was using the wrong assumed growth rate. Lately, and specifically in the case of valuation of hyper-growth companies, we are being told that there is a third way to be wrong – using too short a time horizon. A new valuation method has appeared that stretches the old discounted cash flow calculations to their limits.

Looking to the Horizon

This new valuation method evolved from work that has been done among risk managers. Risk managers and strategic planners have lately become more and more interested in how to capture extreme outlier situations in their analysis. Extreme outlier situations are occasions where actual results diverged so far from expectations that initial analysis was made to look totally ridiculous. Let me give you an example.

In 1980, IBM did a study of the potential market for personal computers that concluded that 275,000 of them would be in use by 1990. As a result, very generous contracts were signed with Intel and Microsoft to build key components for these machines. When the actual installed base of PCs reached 60 million units that year, it was apparent that the study had made some shaky assumptions. And IBM had transferred an enormous amount of wealth to two new companies that were now formidable competitors. One commentator has referred to this as the greatest business mistake in history.

The point is that if even a tiny probability had been allowed for huge upside in the PC market, it might have altered the decision so that IBM could have better protected its interests. For example, IBM may have included volume discounts, or second-supplier options, in the Intel and Microsoft contracts. Identifying potential hyper-growth upside, in other words, can be very valuable to ongoing business decision-making.

A brilliant Toronto-based risk management specialist named Ron Dembo has come up with a rigorous approach called "scenario analysis" to help in this task. Under scenario analysis, a variety of possible futures are postulated for an investment, and probabilities are assigned. Resulting expected values can then be tested for sensitivity to various assumptions. It is only natural that this tool should be adapted for use in the investment industry, especially in the analysis of hyper-growth companies, where growth is rapid but data trails are short. But I should emphasize that the basics of this approach are identical to those we have traditionally used – what is different is the use of more than one future. In other words, you don't just go with the most likely outcome, you develop several likely outcomes and then assess them against relative probabilities. It's not really that much of a stretch.

We have all heard from various sources the statement that "the old valuation methods don't work anymore." But the only new method of valuation I have seen is scenario analysis, and it is not really that much of a departure from traditional DCF analysis. What is really amazing to us is that the suggestion that the old methods don't work is then used as a rationale for buying the most expensive stocks in the market. To me, that's like claiming that the law of gravity has been superseded, and then using that as justification to jump off a cliff. One would think that a feeling that the old methods are inadequate should spark a search for new methods that do work, rather than reckless investment activity. Certainly that is how we are approaching scenario analysis.

I was fortunate to have an example of this type of analysis come across my desk a few weeks ago, and I took some time to roughly reconstruct it to assess its merits. I should stress that my version of the model is quite rough and ready, and incorporates little of the subtlety and scope of the original. But I think it's approximately right. The subject of the scenario analysis is Amazon.com. I would like to emphasize that I am using this example for illustration purposes only. You won't find Amazon.com in your portfolios anytime soon. We'd have a lot of due diligence and valuation work to do before that could happen.

AMAZON.COM INCOME STATEMENT (IN $ MILLIONS)

	1995	1996	1997	1998	1999
Sales	.51	15.8	147.8	610.0	1639.8
Cost of Goods	.41	12.3	119.0	476.2	N/A
SG & A	.41	9.4	61.4	195.6	N/A
Operating Income	-0.3	-6.0	-32.6	-61.9	-330.0

Source: "Valuing dot-coms"., *The McKinsey Quarterly*, 2000, No. 1

Now Amazon is a pretty amazing company. In 1995, it sold only $510,000 worth of goods. Last year, it sold over $1.6 billion. Above is the income statement for the last five years. The growth trajectory is awe inspiring, and so are the operating losses. As you can readily imagine, attempting a valuation of Amazon.com is challenging, because the future could hold a huge variety of outcomes for the business. If, for example, it can begin to generate a margin on its burgeoning sales, it could become a real money-spinner. If the economic advantages that Amazon's business model seem to promise are realized, then the profits could be spectacular. And if profitability is indefinitely postponed, competition heats up and access to capital dries up, Amazon could find itself in real difficulty. Scenario analysis simply takes those alternative futures and tries to examine them dispassionately.

The authors of the analysis I read use four different scenarios for the future of Amazon.com. Each scenario makes different assumptions about the eventual cost structure and growth rate of the company. Scenario A has Amazon turning into a stunning success story, with large and sustainable cost advantages over normal retailers in terms of working capital turnover and buying power. It has 15% of the U.S. book market, 18% of the music market, and sells $49 billion worth of other goods, while generating $12 billion in cash flow in 2010. The analysis further assumes that Amazon continues to grow at 12% compound for the period 2010 to 2025, and at 5.5% from 2025 to 2040. The resulting cash flow stream is discounted back to the present at a discount rate of 13.8%, or at least that is the number I derived.

AMAZON.COM SCENARIO A (IN $ BILLIONS)				
	1999	**2010**	**2025**	**2040**
Revenues	1.639	85.0	647.9	1371.0
Operating Income	-0.330	12.0	91.5	193.6
Growth Rates 1999 – 2010 = 43.2% 2010 – 2025 = 12.0% 2025 – 2040 = 5.5% Discount Rate = 13.8%				
Net Present Value	$79 billion	$241.78/share		

Scenario B has the company with superior but not awesome economics, generating $7 billion of cash flow on $60 billion of sales in 2010.

AMAZON.COM SCENARIO B (IN $ BILLIONS)				
	1999	**2010**	**2025**	**2040**
Revenues	1.639	60.0	328.4	695.0
Operating Income	-0.330	7.0	38.3	81.1
Growth Rates 1999 – 2010 = 38.7% 2010 – 2025 = 12.0% 2025 – 2040 = 5.5% Discount Rate = 13.8%				
Net Present Value	$37 billion	$113.24/share		

Scenario C has Amazon growing to a mere $41 billion of sales in 2010, while taking 10% market share in books and 8% in music, and generating $3.3 billion in cash flow.

AMAZON.COM SCENARIO C (IN $ BILLIONS)				
	1999	**2010**	**2025**	**2040**
Revenues	1.639	41.0	171.3	362.4
Operating Income	-0.330	3.3	13.8	29.2
	Growth Rates 1999 – 2010 = 34.0% 2010 – 2025 = 12.0% 2025 – 2040 = 5.5% Discount Rate = 13.8%			
Net Present Value	$15 billion	$45.90/share		

Scenario D has Amazon growing to only $17 billion in 2010 sales, with traditional retailer economics.

AMAZON.COM SCENARIO D (IN $ BILLIONS)				
	1999	**2010**	**2025**	**2040**
Revenues	1.639	17.0	93.1	207.8
Operating Income	-0.330	1.2	6.6	14.7
	Growth Rates 1999 – 2010 = 23.7% 2010 – 2025 = 12.0% 2025 – 2040 = 5.5% Discount Rate = 13.8%			
Net Present Value	$3 billion	$9.18/share		

Using these scenarios, probabilities can be assigned to each, and a variety of possible valuations arrived at. It is a way to assess the market's current expectations of the future of Amazon.com. We can draw our own conclusions about how reasonable those expectations are.

Now compare this analysis to the DCF analysis of CanWest Global. First, the Amazon model is very back-end loaded. The assumption of rapid growth far into the future gives very large numbers in the out years, which overwhelms the usual effect of discounting. The CanWest model, by contrast, accrues a good part of its value in the first five years. In the Amazon model, under all scenarios, the value of the DCF stream is nominal or negative over the first five years, and still modest after 10 years. The key assumption from a valuation standpoint is the high rate of growth after 2010.

There are a couple of things about this analysis that are troubling to us. One is the long time horizon. Ten years is the extreme outside limit of anybody's forecasting capabilities, and the room for error is huge. If you had asked anyone to forecast what the economy would look like at the end of any decade of the past century, they would have been very lucky to be anywhere close. I would submit that the radical changes of the past 10 years have made that forecast even harder to make.

Another problem is the absence of a failure scenario in the analysis. The worst case envisaged for Amazon is that it ends up looking like a traditional retailer. While that fate is grim indeed, it is not the worst that can happen to a business. Amazon has not as yet shown any ability to generate accounting profits or even positive cash flows, and is reliant on the capital markets for its growth capital. A future bankruptcy is surely not completely out of the question.

But that doesn't mean we can't learn from this analysis. I think that there is much to recommend Mr. Dembo's scenario analysis, and we will be experimenting with it. I see no harm in extending time horizons as part of the normal sensitivity analysis, and we are currently looking at the impact of doing that. This kind of analysis can help us to track the trajectory of some of these hyper-growth situations, and give us some idea of valuation over the long term. It seems to us that this kind of analysis is more familiar than strange.

Following Fisher

So there is nothing in the valuation area that is overly new to us. Can we look to a prominent investor for guidance in this area? Burgundy likes to follow the methods of successful long-term investors. As all of you know, value investing is a pretty big tent. Basically, though, most people feel that there are two kinds of value investors: Ben Graham value investors, who look for a margin of safety in the balance sheet, and Warren Buffett investors, who look for a margin of safety in the economic characteristics of the businesses that they buy. But there is another strand of value investing that has attracted little attention in recent years. That is the Phil Fisher style.

Phil Fisher is a legendary investor based in San Francisco, where he has been managing money since 1931. He evolved a system of assessing companies, and a style of holding very concentrated portfolios for the very long term. His basic approach is to insist on an outstanding management with strong technological leadership.

Buffett acknowledges his debt to Fisher, since Fisher was arguably the investor who discovered the power of holding great companies forever. But Buffett dislikes technology investing because of the complexity factor, where Fisher embraced technology early in his career, and has held Texas Instruments and Motorola for over 40 years without selling. In his book *Common Stocks and Uncommon Profits*, Fisher has a 15-point agenda for what to look for in an equity investment. Interestingly, his first point talks about prospects for large increases in sales, his second point questions the company's determination and ability to develop products or processes so that growth can be sustained, and his third point asks about the size and efficacy of research and development efforts at the company. So to Phil Fisher, technology was a mainstream sector for value investing. He seems to view research and new product development as a part of a company's "moat," to use Buffett's parlance.

Fisher's modern heir would appear to be Bill Miller, manager of the Legg Mason Value Trust, and owner of a tremendous long-term record of performance. Mr. Miller has made a lot of money investing in technology stocks, and he recently wrote a thought-provoking essay entitled "Amazon and the Ethics of Belief." In it, he challenges value investors with the following words: "Many value investors have chosen to ignore technology companies or maintain minimal exposure to them, despite long data trails and compelling evidence that this sector has the ability to create substantial, long-lasting shareholder wealth. The reasons given are that technology is difficult to understand, that it changes rapidly, and that the stocks are usually too expensive according to standard valuation methods." [55]

Mr. Miller believes, like Ben Graham, that reward in the stock market should be related to the amount of work one is willing to do. In one of his more striking statements, he says: "Investors who rule out the largest sector of the stock market, and the most important driver of economic growth, because it takes work to figure it out, have little to cavil about when others get the rewards." [56]

Well, that strikes close to home. We have used some of that type of reasoning at Burgundy for not investing more in technology. Given that we work pretty hard at understanding the companies we invest in, it seems a bit rough to be accused of intellectual laziness, but clearly, Miller is on to something. We have already seen, I think, that the methods of valuation being used on even the most challenging technology situations are not very much different from those we use anyway. So obviously, the main difficulties value managers have with technology investing are qualitative, not quantitative. And it is precisely in the qualitative assessment of businesses that Burgundy excels. So, I conclude, what is there to keep us from being successful technology investors? Nothing, it would seem, but hard work, something we have never been averse to at Burgundy. After all, companies like First Data, Intel, Gennum and Equifax have very substantial technological elements, and we have made a lot of money in them, so we even have a pretty good, though limited, track record.

Our young analysts are very keen to tackle this area. They have already started, and are identifying niches for Burgundy to compete in. Sanjay Sen will be the wheel horse of this effort. Sanjay has an inquisitive mind, and strong valuation skills. Craig Pho will be part of the group too, while keeping his main attention on Japan. Craig brings some knowledge of Japanese technology to the table, as well as his large reserves of common sense and discipline. When Curtis Gazdewich joins us in May, he will join this team. Curtis has an intuitive feel for technology, which I think will give us another dimension in our analysis. This is not a defensive move for Burgundy. We are too young a firm to play defence. We are out to build another competitive advantage in our company in technology investing, and another way for our clients to make money.

So that is Horatio's answer. Any investment worthy of the name is dreamt of in our philosophy. Our valuation techniques may require fine tuning, but there is no radical alternative valuation method that has been proposed. Discounted Cash Flow analysis is still the way to go, albeit a DCF analysis with some differences. The major barrier we have to surmount is simply the background that we must develop in the industry. And we have already started to aggressively develop that background. It will take some time, and we are not willing to compromise our views on valuation, but we will do the work, and reap the rewards. We are confident that we can remain our rational, empirical selves, and invest successfully in technology companies. So don't worry, Horatio is not about to become Hamlet.

Because after all, at the end of the play, Hamlet is dead, along with his mother Gertrude, his uncle Claudius, his fiancée Ophelia, his best friend Laertes and the old councillor Polonius. And those are just the ones who died onstage. Horatio, by contrast, is last seen being treated with honour and consideration by the new King of Denmark, and, no doubt, lives on to a ripe and prosperous old age. The moral of the story, I think, is obvious.

Author: **Richard Rooney, President and Chief Investment Officer**

December 2000

Indexers, Arbitrageurs and Organ Donors

The investment strategy that has been the biggest winner with clients in the last quarter century is neither a growth strategy nor a value strategy. It is index investing, known in the trade as "indexing." From a standing start in 1976, there are now more than $1 trillion in funds indexed to the Standard & Poor's 500 Index. And Sanford Bernstein, the U.S. broker and money manager, estimates that 40% of U.S. pension equities are more or less closely tied to various indexes. At Burgundy, we look for the strengths and weaknesses in a given approach and try to integrate the strengths into our own methods. So in this issue of *The View from Burgundy*, we are going to take a look at the evolution of indexing from its theoretical and historical roots. We will then look at the S&P 500 Index to assess its specific strengths and weaknesses. After that, we will discuss how some investors have differentiated themselves from index funds, and what strategies hold out the best prospects for success in "beating the market."

What Is Indexing?

Indexing is the construction of a portfolio that mirrors the precise weightings of a popular benchmark like the TSE 300, the S&P 500 or the Nikkei 225. These indexes are chosen from representative companies trading on a stock market in order to give an objective measure of how that broad stock market is performing. Since the weights of these companies in relation to one another are known, it is possible to construct an index portfolio that will closely track the performance of that index. The goal of indexing, by and large, is to minimize the difference between the return on the index portfolio and that of the actual index. That difference would be called the "underperformance" or "outperformance" in the falsely dynamic terminology of active management; indexers, who affect an Olympian objectivity, call it "tracking error."

The intellectual basis of indexing lies in a theory called the efficient markets hypothesis.

The Efficient Markets Hypothesis

The stock market has long fascinated academics. By the 1950s they had begun to study an apparent anomaly: most active managers seemed to underperform broad market proxies in any given year. Starting in 1952 with Harry Markowitz's seminal article in the *Journal of Finance*, Modern Portfolio Theory began to emerge. William Sharpe and other quantitative pioneers followed up and fleshed out the theory, which was popularized by Burton Malkiel in his 1973 classic, *A Random Walk Down Wall Street*. Both this intellectually ambitious theory of finance, and its refinement, which is known as Arbitrage Pricing Theory, are based on the efficient markets hypothesis.

An efficient market is made up of a large number of investors who are all seeking to maximize their returns. They use all available sources of information and approach their task in a rational manner. While individual investors may be able to use unique insights to outperform the market for short periods of time, such occurrences are essentially random because all relevant information is processed by the markets. Therefore, long-term systematic outperformance of the broad markets is impossible, according to this hypothesis.

Such a sweeping indictment of active management required corroboration, which unfortunately was forthcoming in abundance. A glance at a recent survey of Canadian managers shows what we all know to be true – active managers tend to underperform their benchmarks. For example, using the William M. Mercer Limited Investment Performance Survey at September 30, 2000, the five-year return on the S&P 500 Index was slightly above the first quartile break for the managers in the survey (i.e., it had outperformed more than 75% of U.S. equity managers over the past five years). That has been a fairly consistent result for the past decade or more. For Canadian equities, the result is less dramatic, with the TSE 300 Total Return Index edging out the median manager's five-year return by 30 basis points (0.3%).

So active managers have a lot of trouble consistently beating the index averages. Why would that be?

Let's start with a simple observation. The average manager will never beat the index in the long run because the index does not exist in nature – real portfolios bear real costs that do not show up in the calculations of index averages. And any random aggregation of managers accounting for more than about 10% of the market will approximate the market portfolio, so differentiation based on portfolio composition disappears quite quickly. By definition, the average money manager should underperform to the extent of his management fees and related costs.

Those costs are what might be called the structural disadvantage of active managers relative to indexes. While significant, they do not account for the entire performance shortfall. What accounts for the remainder? We think that there are two reasons: first, the dysfunctional investment methods that most money managers use, and second, some inherent advantages of index investing.

The Inefficient Manager Hypothesis

In January 1965, Warren Buffett wrote a letter to his limited partners on the subject of the ineffectiveness of money managers. He attributed the problems of active managers to five factors: group decision-making; desire to conform to peer organizations' policies and portfolios; an institutional framework where rewards for independent action are far outweighed by the risks of such action; adherence to irrational diversification practices; and inertia. As usual, Buffett's opinions met with no interest from the academic world, probably because they were just common sense and were expressed in plain English.

His diagnosis is immediately recognizable to anyone who has studied a mature money management organization. At some point in their life cycles, investment counsellors begin to play defence and to look to successful peers for a model. Overly large investment departments give rise to "teams" where blame can be equally borne for the inevitable disappointments and mistakes. The extreme benchmark orientation of clients leads to a tendency to increasingly mimic the benchmark. Mistakes are remembered and savoured; victories are attributed to luck or forgotten. The portfolio managers are never wrong; they are just underweighted or overweighted. So the rational pursuit of maximized returns is not the goal of these organizations; mediocrity is – the magic 49th percentile position. And the way to get there is to mirror the index as closely as possible without having the client catch on, a process known as "closet indexing."

So institutional investors do not fit the model of an efficient market based on rational, return-maximizing investors. Do individual investors fit the model? In the 1980s and 1990s, with the proliferation of individual investor involvement in the capital markets through mutual funds and direct investment, academic research on retail investor behaviour became possible. A branch of economics called behavioural finance arose, and discovered what anyone who has ever bought a stock in the market knows already – that people who invest for their own accounts are not coolly rational; in fact, they are often scarcely sane.

What the behavioural finance theorists found was that most people invest in order to minimize anticipated regret. They are always asking themselves how stupid they will feel if they screw up. Regret usually results from doing something different from others, or not doing something that others have done. (Remember the ugly fate of that small town in Alberta where half the population bought Bre-X stock and the other half didn't? It should have been renamed Regretsville – for both halves.) The implication is that most investors would rather be wrong in a group than right all by themselves. "You have only yourself to blame" is the phrase most feared by the investing public, just as it is by portfolio managers in large institutions.

Given this entirely human fear, it is no wonder that indexing taps deep psychological roots. After all, the index return is what everybody gets – it's impossible to get left out or to miss a move. If you do badly in absolute terms, so will almost everybody else. And you'll rarely do too badly in relative terms. The margin of safety here is a psychological one, not a financial one.

So investors, both individual and institutional, are not exactly primed to compete against a tough benchmark. Let's look at perhaps the toughest benchmark of all – that 500 stock gorilla, the Standard & Poor's 500.

The S&P 500 – An Elite Index

Like the quality performers in any field, the S&P 500 Index does not boast in its self-description. The S&P website proclaims simply that "this popular index includes a representative sample of leading companies in leading industries." [57] For those needing more information, another page states that the Index "consists of 500 stocks chosen for market size, liquidity, and industry group representation... with each stock's weight in the Index proportionate to its market value." [58]

The Index has traditionally been chosen (in profound secrecy, by an Index Committee of Standard & Poor's employees) from among America's finest and largest companies. It is quality-biased and liquidity-biased. Industrials constitute about 75% of the Index (though in this context, "industrials" simply means non-regulated businesses), utilities are about 8%, financials are 15% and transportation companies are 2%. Currently, 432 of the companies are NYSE listed, 66 are on NASDAQ, and two are on Amex.

And it is a ferocious beast to compete against. When you think about it, it's easy to see why. The kinds of companies included in the Index have been just the kinds of companies that are best known to investors and whose information is most readily available. The very high liquidity of the stocks means that there are minimal barriers to entry or exit. And the broad diversification means that, in Buffett's phrase, you have substantial protection against lack of knowledge. In terms of efficient markets theory, you have liquidity and readily available information, the two main prerequisites for an efficient market.

But we believe there are three other crucial factors in the success of the S&P Index and the funds that mimic it. First is the quality bias. There is a great deal to be said for buying only leaders in their field, and that is what the S&P 500 Index does systematically. Industry leaders tend to have competitive advantages, and usually the best financial results in an industry, so the S&P system has traditionally selected the cream of the crop, using Jack Welch's approach to business.

Second, the index fund is the ultimate long-term investor. While there are changes due to mergers, takeovers and bankruptcies, most core stocks in the S&P 500 have remained unchanged for decades. Turnover has been a fraction of that in the average manager's portfolio.

The last advantage is related to the low turnover. Because they must minimize "tracking error" in order to replicate the index performance (remember, the Index itself bears no costs), index fund managers are obsessive about costs of all kinds. They avoid trading costs through passivity, as we have seen, and through attempting to minimize the market impact of all trades. And management fees and custody fees, two other major expenses, decline rapidly in percentage terms as size increases. In fact, index funds get better and better at what they do as size increases, an accusation rarely levelled against active managers.

So S&P 500 Index funds are diversified, quality-biased, liquidity-biased, long-term buy-and-hold investors who minimize activity as a means of reducing costs. It is undeniable that this has proven to be a reliable way to invest for good returns over the past quarter century. But are there potential weaknesses in the index approach?

A couple of potential problems do suggest themselves. First, the concern with liquidity can lead to some peculiar results. For any investor, liquidity is a weak reed to lean upon; as David Swensen, Yale's brilliant Chief Investment Officer puts it, when you really need liquidity, it isn't there. What he means is that liquidity is not a constant – it comes and goes in an unpredictable way, and dries up completely in tough times. And one odd by-product of the Index Committee's liquidity obsession is that Berkshire Hathaway, one of the most successful companies in history, with a $100 billion market capitalization, is not included in the S&P 500 Index because its shareholders insist on holding it rather than trading it actively.

The other problem that could arise is with the brief of the S&P Index Committee. They are supposed to make the Index roughly reflect the make-up of the U.S. economy. But in putting that brief into effect, they may find themselves influenced by market manias. For example, in 2000 so far, there have been 41 deletions from the S&P 500 Index, a vastly higher level of turnover than at any time in history. The additions came overwhelmingly from the very expensive companies representing the "new economy." The Committee did not fall for the "tech boom" hook, line and sinker; they continued to emphasize profitability and strong financial position in their selections. On inclusion, these stocks were, no doubt, very liquid and had large market capitalizations. The size of their businesses is somewhat more open to question.

For example, seven technology stocks that were included in the Index were Broadvision, Palm, Broadcom, Mercury Interactive, Maxim Integrated Products, Siebel Systems and Linear Technology. Their average P/E ratio is 155.7 times trailing earnings, and they sell at a rather lofty average of 22.9 times sales. As an index investor, you must invest in these companies whether you think it is a good idea or not. You have subcontracted your stock selection to the S&P Index Committee, and you have no say in the matter. But including $139 billion in market capitalization on a base of $6 billion in gross revenues and $890 million in net income is not something we would encourage; it just doesn't sound like a blue chip stock valuation to us. And we are saying nothing about the AOL/Time Warners, Yahoos, Oracles and Ciscos that are the real heavyweights of the Index. They are fine companies and deserve to be there, but their index weights and valuations are scary, even after the brutal shellacking they have taken in the last seven months. But maybe these are only the musings of someone who lacks total confidence in market efficiency.

Beating the Index

What strategies have managers developed to beat index averages? Generally, they all have something in common: they try to go where the market is least efficient, and own something outside the benchmark. For example, John Templeton was a pioneer in international investing because foreign markets have always been much less efficient than American ones. Investors like Peter Lynch and John Neff had a preference for smaller capitalization companies where both liquidity and information flow were inferior to S&P 500 stocks.

Warren Buffett is an interesting study for investors thinking about market efficiency. Like the Index, he uses an almost infinite holding period. And his public investments have almost always been stocks that were included in the S&P 500 Index. But instead of diversification, he seeks concentration. Instead of good businesses, he seeks great ones. If you can identify a company that can grow reliably at an even slightly faster rate than the market as a whole, and you hold that investment for a very long time, then that seemingly small difference in growth rates will lead to a dramatically higher value for your investment in the long term. If that difference is more like three or four percentage points, then the result is dramatic. A $1,000 investment in a common stock that grows at 11% for 30 years would be worth $22,892 at the end of the holding period. One that grows at 15% would be worth $66,212! Buffett has compounded his money and that of his shareholders at more than 20% for his entire career, dating back to the early 1960s. His career is proof that performance does not necessarily revert to the mean in the long run, as efficient markets theory would suggest. But looking at his performance over decades, he has often underperformed the S&P Index, sometimes substantially, on a calendar year basis. That reveals a vital truth of buy-and-hold investing: you must often underperform an index in the short term in order to outperform it in the long term. Client demands for "consistent" performance relative to a benchmark lead only to closet indexing.

Buffett also has a profound anti-activity bias. With his usual knack for the revealing example, he has put forth the idea that everyone would be a better investor if they were restricted to 20 investment decisions in a lifetime – he refers to it as having a "20-punch lifetime bus ticket" for investments. Unfortunately, most investors succumb to the lure of activity for activity's sake.

Buffett has been one of the very few investors with the perspicacity to pick outstandingly reliable businesses and the patience to hold them forever. He has spawned many imitators, especially in the last 10 years, but very few of them have either his stock-picking ability or his patience. But we think he beats the heck out of the S&P Index Committee as an exemplar, and we say that with a great deal of respect for the Committee.

Our conclusion? A concentrated buy-and-hold portfolio of great companies that grow faster and use capital more efficiently than the average company is probably the best way to beat the S&P 500 using the stocks in the Index. More active strategies would have the best chance of beating this tough benchmark if they owned stocks that are not included in the Index (for example, small capitalization stocks). There is also evidence that the ability to short stocks could be a value-added strategy, since most market participants are not allowed to sell short.

Market Efficiency – An Ideal

Many active managers scoff at the idea of market efficiency, despite the strong evidence for some form of it. We have a little different take on it: we view it as an ideal rather than a reality. A market where all investors are rational, where information is seamlessly processed into stock prices with ample liquidity and where information is simultaneously available to all investors – that would be a stock market that was really doing its job.

That isn't how the stock market appears to us. Investors look like a pretty irrational bunch who are very prone to manias and phobias. They were frantic to buy Japanese equities in 1989 and technology and Internet stocks in 1999-2000. Most people would today recommend Japanese stocks only to their very worst enemies despite their compelling valuations. If current trends persist, technology issues will command similar affection before too long. However these investments were rationalized by the people involved, they were never rational at the time of the mania, nor will they be during the phobic stage that follows. The assumption that information is immediately available to be assimilated by the market is truer all the time, but remains a goal rather than a reality, even given the Herculean efforts of Chairman Arthur Levitt's SEC. And liquidity is ephemeral – it will come and go, so you had better be sure of the business. We suppose one could say that during normal times the stock market is quite efficient. Perhaps it's just that our partners have never experienced normal times.

Conclusion

Last spring, we wrote in a client report that we thought the next two to three years would be the best in history for value managers. With a buy-and-hold, quality-biased philosophy, the right exemplars and the still-massive distortion of the indexes by the technology mania, we really like the position of value managers against the benchmarks for a long time to come.

So we'll continue to look for value anomalies among the companies we follow and exploit them for our clients. Efficient market theorists no doubt look on investors like us with the same benevolent condescension that Plato's philosophers had for the believers in the Golden Legend. At least they think we're socially useful, an essential part of the great arbitrage mechanism that is the stock market.

As for the social usefulness of closet indexers, there's this little organ donor card that comes with your driver's licence...

Author: **Richard Rooney, President and Chief Investment Officer**

May 2001

A Year of Living Dangerously

Richard Rooney, CA, CFA, President of Burgundy, gave the following speech at Burgundy's Client Day on May 8, 2001.

When you saw the title of my presentation today, I expect you thought we were going to review last year's peculiar markets. That would have given us the opportunity to indulge in false humility or blatant self-congratulation, thus confirming all your worst suspicions about money managers. But the title doesn't refer to last year. It refers to this one.

A review of last year would have been quite amusing, since there was an unusual degree of human folly on display, even by the exacting standards of Wall Street and Bay Street. But, as my mother would say, that would "butter no parsnips." A year ago, improved returns for Burgundy were inevitable – our stocks were compelling value and most others were not. In that situation, all a value manager must do is await the correction and hope that he or she still has some clients left when it occurs. Fortunately for us, we have patient clients.

Last year, what you wanted was assurance that we had a technology strategy and were not just indulging in willful ignorance. What do you want to know this year? If I were you, I'd have three questions. First, as we look to the future, what are we worried about? Second, which worries are likely to be valid ones? Third, how do we prudently seek good returns in light of these concerns?

Addressing the future is always a hazardous undertaking. Dan Quisenberry, the hard-throwing right-hander for the Kansas City Royals in the 1980s, was once asked about the future. After a brief pause for thought, Dan said that he thought the future would be much like the present, only longer. With such a grasp of the essentials of financial forecasting, Dan could have had a second career on Wall Street. But he illustrates an important point – it is difficult to uncouple yourself from your present and recent past, and see your situation in historical context. I am going to try to do that today.

Our worries fall into three categories. First is the economy. I'm going to spend a few minutes on top-down economics, even though we usually don't do that. Second is a related matter – the impact of a very weak or very strong economy on our relative performance. The last worry is about valuation and growth expectations in the equity markets. My goal is to assess these concerns, select the valid ones and devise a prudent strategy to protect our clients' capital.

Let's turn to top-down economics.

I've prepared four slides that each show a perfectly plausible conception of where the world could go over the next five years. Chart No. 1 is entitled Apocalypse Now. In this world, North America goes into deep recession as the consumer pulls in his belt and, at long last, saves some money. Japan remains mired in difficulties, China's economy stalls and the world economy declines for the first time since World War II. This world is brutal for equities and good for bonds, as you see.

CHART #1 – APOCALYPSE NOW

Probability – 10%

- North America goes into deep recession
- Japan deteriorates further
- China goes into crisis
- Worldwide economic slump worst since World War II

Five-year Expected Returns

Bonds	9.0%
Equities	(10.0)%

Chart No. 2 is named after Doctor Pangloss, the idealistic professor from Voltaire's *Candide* who had an unshakeable conviction that "everything is for the best in this best of all possible worlds." [59] In this world, the U.S. economy doesn't miss a beat, and continues to grow. Japan begins to recover, and Europe becomes a modest engine of growth. This world is great for equities and not so good for bonds.

CHART #2 – DR. PANGLOSS	
Probability – 10%	
• North America continues slow growth • Japan and Asia recover • European growth accelerates	
Five-year Expected Returns	
Bonds	3.0%
Equities	12.0%

Chart No. 3 is called Hard Landing. North America falls into a sharp recession and drags down world growth rates with it. This is a tough outlook, under which bonds do a little better than coupon and equities are dead money for the next five years.

CHART #3 – HARD LANDING	
Probability – 40%	
• Sharp recession in North America, slow recovery • Gradual recovery in Asia • Slower growth in Europe • Confidence shaken, remains fragile	
Five-year Expected Returns	
Bonds	7.0%
Equities	2.0%

Chart No. 4 is the Soft Landing outlook. A recession in North America is shallow and brief, Asia recovers and Europe continues to grow. Bonds return their coupon, while equities give a reasonable, but below trend rate of return.

CHART #4 – SOFT LANDING	
Probability – 40%	
• Shallow, brief recession in North America • Recovery in Asia • Growth in Europe • No real crisis of confidence	
Five-year Expected Returns	
Bonds	5.0%
Equities	7.0%

As you can see, I weight these outlooks based on probabilities. If you derive the expected values of these outlooks, you will see that the expected returns from both equities and bonds are mid-single digits for the next five years under almost all assumptions.

That's the bad news. The good news is that this is the presentation, almost word for word, that I gave to a client who specifically asked for a top-down review in November of 1998. I plan to continue to give this presentation at 30-month intervals until one of the forecasts comes true. It is pretty remarkable how well the presentation has aged. But it reflects the danger of top-down thinking for people like us. It doesn't look like you should take economic concerns very seriously when your money manager enunciates them; even if we are right about the economy, we are unlikely to understand how financial assets will react to a given economic outcome.

It is perhaps tough to recapture how scary the world looked in the fall of 1998. Russia had defaulted on its debt and non-sovereign bond markets collapsed. Long-Term Capital Management, a huge hedge fund in the U.S., went to the brink of insolvency. Everywhere there seemed to be a deflationary hurricane about to engulf the world. And clearly it affected our thinking. We asked our clients to really go back to the drawing board and decide whether they needed bond exposure in their holdings, and we recommended a holding of 25-35% in fixed income for all accounts where we managed substantially all the clients' wealth, and where there could be a call on the capital within the next five years. That didn't prove to be a bad decision, but a better one would have been to stay in equities.

The actual index returns over the 30 months since our bearish forecast have been consistent with the soft landing outlook – about 5% for bonds and 7% for equities. Burgundy has done a little better, with compound North American equity returns of about 15% over the period. The best investment we offer that you could have made in 1998 was our Japan Fund, which has compounded capital at 25.7% over the 30-month period.

This anecdote shows why bottom-up stock pickers shouldn't get caught up in big picture economic concerns. We should beware of top-down optimism or pessimism and concentrate on understanding the outlook for our companies. It never hurts to re-examine your investment guidelines and to be sure that you really are a long-term investor, but by and large, equities are the place to be if you want to build your wealth. The only question is, which equities?

As all of you know, we tend to invest in a fairly narrow range of industries, such as newspapers and media, consumer staples, financial services, and selected, less cyclical industrials and retailers. They are generally less sensitive to the economic cycle than some other industry groups, and show steady growth in most circumstances. In contrast, some other groups benefit disproportionately from very strong or very weak economies. For example, the technology boom of 1999-2000 was partially touched off by the great strength of the economy in those years. Technology has to some extent replaced bricks and mortar as the thing companies spend their money on late in the economic cycle. If the economy is very strong in the next few years, the tech boom could re-ignite. But I think a return to the crazy days of 1999 is unlikely anytime soon. The valuations are still not sensible, growth expectations are too high and the fundamentals are poor.

Another potential area that would benefit from a strong economy is that of cyclical stocks, which have had a few false dawns in the 1990s, but have yet to seriously embarrass us. One of the surprises of the past six months has been the strong performance of a lot of deep cyclical stocks. In Canada, we have owned Methanex and Cameco, a couple of cyclicals with good balance sheets and strong market positions. They have been among our big winners over the past year because they were purchased at very cheap levels. Some other cyclicals, like the railways and Alcan, have also been acting well. If they continue to do so, it may be evidence that the powers that be have been able to pull off the elusive economic soft landing. A surprise that we haven't seen in many years would be an old-fashioned, Old Economy commodity blow off. It would mainly affect our portfolios in Canada and, in a long shot, Japan because those markets have substantial cyclical weightings. In those markets, our relative returns could suffer. Remember, we don't invest much in cyclical stocks because they are basically bad businesses.

At the other end of the spectrum, if we go into a recession, the regulated utilities have always done well because of their traditionally low business risk and bond-like investment characteristics. But this area may not behave as it used to because broad-based deregulation of energy and telecoms has led to a much more uncertain environment for these companies. And a wave of acquisitions at extremely high prices has left many industry participants with unusually weak balance sheets. So they can't really fill their traditional role as safe havens.

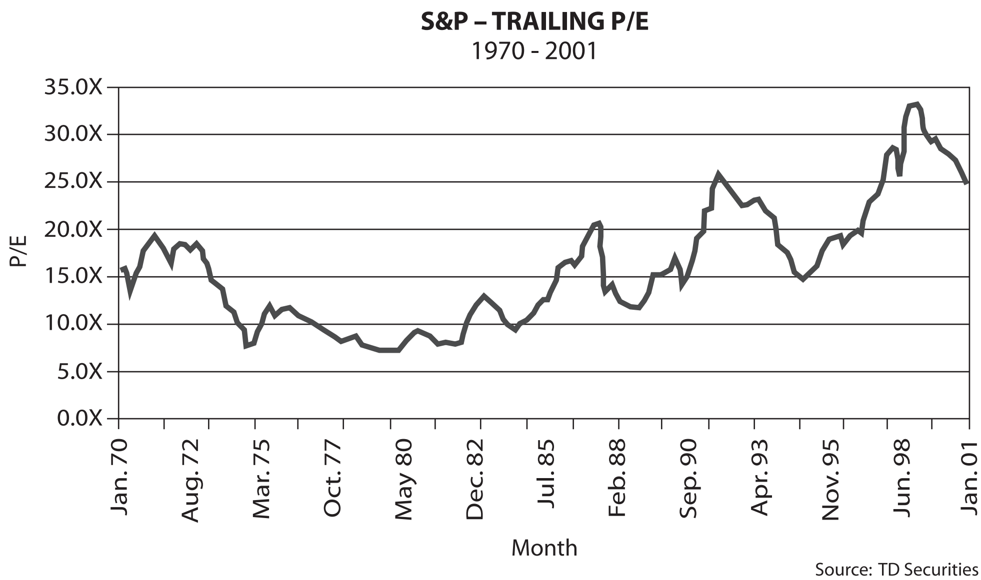
On balance, we are satisfied with the positioning of our portfolios for the coming year. We own companies for all seasons – businesses that do well in most market environments. You've already seen what that means over the past few years: we tend to lag frothy bull markets, grow steadily in trading markets and outperform down markets, sometimes even growing our value against the trend – as long as the trend isn't too strong. We do best when the market is rewarding the economic characteristics of our businesses, and when the valuations of our companies are low relative to competing investments. In other words, we do well in a year like 2000.

Our portfolios in Canada and the United States have appreciated by 30-40% over the past year. The bad news is that our companies are on average over 30% more expensive than they were last year at this time. Value managers try to cultivate a rather peculiar state of mind where our spirits rise as stock prices fall. The contrary is also the case – as prices rise, we should become more and more drawn and haggard. I hope we look sufficiently careworn to convey to you the difficulty of finding value in this market.

What About Valuation?

Let's look at how the whole equity market is positioned in 2001. The overview is not reassuring.

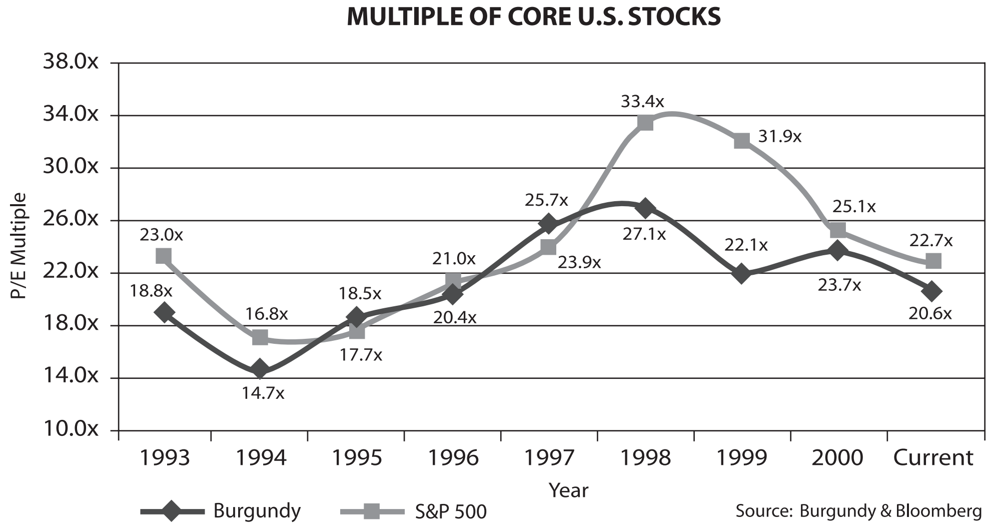
The next chart shows what has been paid for a dollar of earnings of large cap U.S. equities over the past 30 years. Earnings multiples have come down somewhat from the scary levels of last year. But they are still above long-term averages.



What About Our Stocks?

Our stocks are generally trading at about the earnings multiples that they reached in 1996. But the economy in 1996 was strong, unlike today's economy. And in 1996, a huge proportion of the participants in the capital markets had not yet been exposed as frauds and incompetents. That happened in 2000, with the collapse of the bubble.

High valuations should correlate to high confidence in the system. After last year, I believe that almost all participants in the capital markets are to some extent discredited.

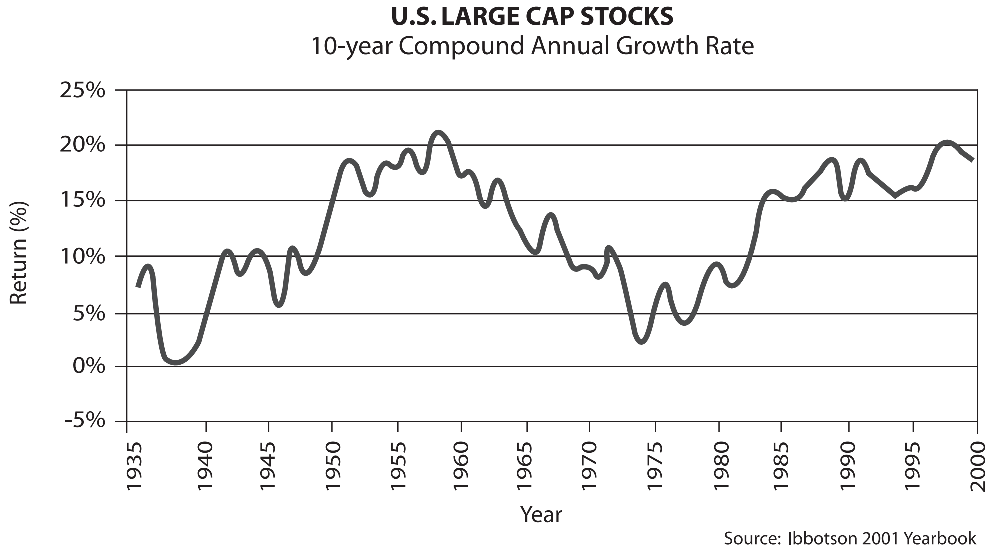


High valuations at a time when the system deserves no confidence make a dangerous combination.

I could show you many charts, all illustrating that in terms of dividend yield or book value or just about any other measurement, the current equity markets in the U.S. and Canada are extended. I could also show you that, relative to those markets, our portfolios are less expensive. But I hope you know that anyway. Let me relate the value problem to you in another way – by thinking about the fundamentals of our companies.

The problem we have whenever we look at our companies is trying to identify sources of long-term volume and revenue growth. That is getting tougher and tougher. The game of reducing costs to increase earnings has pretty much been played out, and a lot of our companies are now in the mode of investing heavily and often belatedly in their businesses to try to grow the top line. That can't be good for corporate profitability either in the short or the medium term. Warren Buffett, in his latest annual report for Berkshire Hathaway, said the stock market outlook for many of his companies was unexciting. We would have to concur about most of our large cap investments. They are not scary, but they are unlikely to deliver the kind of returns they did in the last decade. Single-digit returns are probably the fate of most investors over the next 10 years – Buffett at his annual meeting said 10 to 15 years.

I thought it would be interesting to look at what the distribution of longer-term returns has been. The next chart shows the sequence of all 10-year period returns since 1936 – that is to say, the first point is 1926 to 1936, the second 1927 to 1937, and so on. There is clearly a pattern here. Periods of very high returns are succeeded by long declines as valuations are corrected. This data is probably not meaningful because there are far too few observations to use as a predictor. But the chart would appear to show that – to misquote Shakespeare – there is a tide in the affairs of the stock market, which taken at the ebb, leads on to fortune. In North America, we're at the flood, not the ebb.

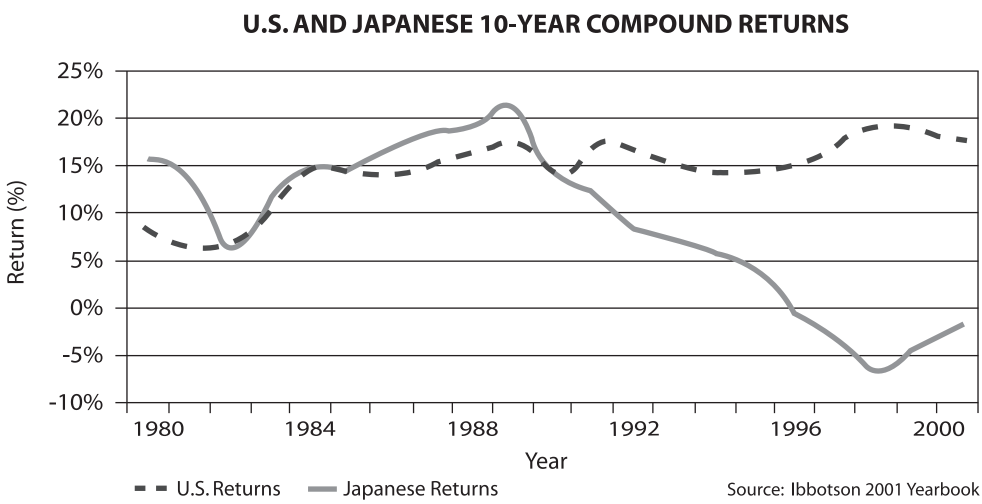


I believe that these last concerns are the valid ones – that value is tough to find in North American markets and that those markets are overdue to disappoint.

So what can we do? Would we recommend that all our clients go into lower-risk but also lower-return asset classes like treasury bills and bonds? No. When all is said and done, equities are the way to build long-term wealth. But we think there is a better way to go. Much as we love the U.S. equity markets, with their liquidity, good governance, and splendid listed companies, there are other opportunities in this world.

Look at this chart of 10-year return sequences for Japanese equities.

I think we can say that, despite the smaller number of observations, there is a very different pattern apparent here. If you want the basis of our strategy for involvement in Japan, take this chart and add a compelling value story. Just to emphasize the point, let's look at the U.S. and Japan together over the same period. I know where I'd rather be.



So where do we go from here?

The byword for the coming year should be caution. If you are a pure equity investor, you should diversify beyond North American markets and look at our Japanese and

European Funds. If the news on Japan appears to be terrible, remember that a year ago, the news on technology stocks was uniformly glowing. Being contrarian usually only looks smart in retrospect – at the time it can, and should, look downright scary. The emergence of an equity culture in Europe is also an exciting development. So the Europe and Japan funds should give you the opportunity to achieve low-risk incremental returns.

If Burgundy manages a very substantial portion of your wealth, and if your time horizon is less than five years, you should place a portion of your money in bonds and treasury bills. If you are satisfied with your current positioning, you should, in any case, be expecting returns from the next five years that are substantially below those of the last five years. For our part, we will develop new products to help in the process of diversification.

It seems likely that we will all get rich slower in the next 10 years than in the last 20. But barring an incursion of the Four Horsemen, I think we will be richer. Our main goal should be to protect ourselves prudently through intelligent diversification. I have mentioned investing in European and Japanese equities as good ways to pursue that goal. It is also a good time for all our clients to sit down and seriously assess their investment objectives and positioning. If you've been aggressive relative to your real situation over the past few years, protect yourself either through diversification into new equity products or through fixed-income positions. Market timing is a mug's game, but correct positioning relative to your needs and risk preferences is essential.

It is entirely possible that when we meet again, my advice will have proved to be wrong, and North American equity markets will have continued to push skyward. That is the problem whenever you say anything definite about investing. That is why so few people ever do say anything definite about investing. And after all, we were wrong about the future in 1998. But people who have been riding the single wave of North American equity markets are living dangerously, and we feel that the time for living dangerously has passed. It will be the prudently diversified investor who prospers in the coming years.

Author: **Richard Rooney, President and Chief Investment Officer**

November 2001

Wise Passivity, Cautious Opportunism

> "To enjoy the benefits of time" was one of the chief maxims of the statecraft of the age. Time untied so many knots, cancelled the necessity for so many desperate decisions, revealed so many unexpected shifts of pattern in a kaleidoscopic world, that the shrewdest statesmen were glad to take refuge in a wise passivity, a cautious opportunism.[60]

The above quotation, though far from its context, could stand as a brief manifesto for the kind of value investing we try to practice. We sometimes tell our clients that we would like to have the same portfolio at the end of a year that we had at the beginning, and try to explain to them how hard we had to work to achieve that level of apparent inactivity. They usually think we are kidding, but we're not. Behaving as an active owner is not the same as just buying and holding.

As the record of index investing over the past couple of years demonstrates, passivity is not a difficult thing to accomplish, nor is it a virtue in itself. Attaching wisdom to passivity is the goal, and it is one that very few investors have achieved. The goal of finding a stock that can be prudently bought and wisely held forever, where we can enjoy the benefits of time, is an elusive one. One attempt to identify a group of such stocks was the famous Nifty Fifty.

The Nifty Fifty

The Nifty Fifty was a group of stocks that constituted the major investment theme of the early 1970s. That was a particularly difficult stock market, where small capitalization stocks were being brutalized and many large companies were floundering as the effects of inflation began to be felt in the broad economy. Just about the only exception to this gloomy rule was the Nifty Fifty, a group of large cap growth stocks with stellar growth records, which seemed to be able to outperform the market averages under any circumstances. They were known as "one-decision" stocks because you could supposedly buy them at any price and never sell them. We thought that it would be instructive to go through the list of Nifty Fifty stocks to see how they have performed over the past 30 years. Our goal is to determine why some companies have prospered and some have faltered, and to draw lessons for investing today.

The origin of our quest was in Jeremy Siegel's 1994 book, *Stocks for the Long Run*. In one chapter, Siegel shows that if you had bought the Nifty Fifty on January 1, 1972 and held the stocks until May 31, 1993, you would have outperformed the S&P 500 Index, despite the excessive valuations of those stocks on the purchase date. Even buying them at their peak prices in January 1973 would have generated a return over the holding period just below the S&P 500 return. So it would appear that investors were right about the general quality of the Nifty Fifty stocks, to the extent that even purchasing at very high valuation levels was a small relative penalty in the very long term.

Exhibit 1
THE NIFTY FIFTY

3M	J.C. Penney Company, Inc.
Am. Home Prod Corp.	Johnson & Johnson
Am. Hospital Supply Corp.	Jos. Schlitz Brewing Co.
American Express Co.	K-Mart Corp.
AMP Inc.	LA Land & Exploration Co.
Anheuser-Busch, Inc.	Lubrizol Corp.
Avon Products, Inc.	McDonald's Corp.
Baxter Intern'l Inc.	Merck & Co.
Black & Decker Mfg.	MGIC Investment Corp.
Bristol-Myers Co.	PepsiCo Inc.
Burroughs Inc.	Pfizer Inc.
Chesebrough-Pond's Inc.	Philip Morris Cos. Inc.
Citicorp	Polaroid Corp.
Digital Equip. Corp.	Procter & Gamble
Dow Chemical Co.	Revlon Inc.
Eastman Kodak Co.	Schering Plough Corp.
Eli Lilly & Co.	Schlumberger Ltd.
Emery Air Fght. Corp.	Sears, Roebuck & Co.
General Electric Co.	Simplicity Pattern
Gillette Co.	Squibb Corp.
Halliburton Co.	Texas Instruments Inc.
Heublein Inc.	The Coca Cola Co.
IBM	Upjohn Co.
Intern'l Flavors & Frag	Walt Disney Co.
ITT	Xerox Corp.

Our Sample

Time has not been kind to all members of this elite club. A number of its constituents have disappeared, either through takeovers (Squibb, Digital), breakups (ITT) or bankruptcy (Polaroid). Several others were excluded because they are now rather small relative to their former peer group. We ended up with a sample of 29 companies, most of which are still mainstays of corporate America. These 29 stocks are shown in Exhibit 2.

We subdivide the 29 stocks into seven industry groups, namely Financials, Retailers, Sin Stocks, Pharmaceuticals, Consumer Goods, Technology, and Industrial Products. The groupings are ours, and not those of any index.

In the right column, we show the total return since May 31, 1993. In the left column, we update the returns from Siegel's book to give a 29-year, 10-month compound return.

Exhibit 2

SAMPLE RETURNS [61]

	Since Jan. 1, 1972	Since May 31, 1993
FINANCIALS		
American Express Co.	11.3%	18.0%
Citigroup	14.4%	29.4%
Average	**12.9%**	**23.7%**
RETAILERS		
J.C. Penney Company Inc.	4.8%	-5.1%
K-Mart Corp.	0.7%	-13.0%
Sears, Roebuck & Co.	6.8%	11.4%
Average	**4.1%**	**-2.2%**
SIN STOCKS		
Anheuser-Busch Inc.	12.8%	17.6%
Philip Morris Cos. Inc.	19.3%	18.7%
Average	**16.1%**	**18.2%**
PHARMACEUTICALS		
Merck & Co.	15.4%	17.9%
Pfizer Inc.	16.7%	27.9%
Schering Plough Corp.	14.6%	21.7%
Bristol Myers SQ	15.8%	20.5%
Eli Lilly	10.2%	26.4%
Johnson & Johnson	13.8%	23.5%
Average	**14.4%**	**23.0%**

Source: Stocks for the Long Run, Bloomberg

EXHIBIT 2

SAMPLE RETURNS (CONTINUED)

	Since Jan. 1, 1972	Since May 31, 1993
CONSUMER GOODS		
Avon Products, Inc.	7.0%	18.2%
Gillette Co.	15.2%	15.2%
The Coca Cola Co.	13.6%	11.8%
McDonald's Corp.	12.8%	9.9%
Walt Disney Co.	10.3%	3.5%
Procter & Gamble	12.6%	16.1%
PepsiCo Inc.	16.0%	15.3%
Average	**12.5%**	**12.9%**
TECHNOLOGY		
Xerox Corp.	0.1%	-4.6%
Texas Instruments Inc.	12.6%	26.7%
Eastman Kodak Co.	3.5%	-2.8%
IBM	9.8%	29.5%
Average	**6.5%**	**12.2%**
INDUSTRIAL PRODUCTS		
General Electric Co.	15.5%	22.6%
Schlumberger Ltd.	11.8%	8.0%
Intern'l Flavors & Frag	7.3%	-0.4%
3M	10.0%	11.0%
Dow Chemical Co.	11.4%	11.1%
Average	**11.2%**	**10.5%**
Total Sample Average	**11.2%**	**14.0%**
S&P 500 Index	**12.0%**	**12.8%**

Source: Stocks for the Long Run, Bloomberg

The results are rather interesting. Sin Stocks did best, although the sample size is only two, and Philip Morris is the best stock of the 29. Pharmaceuticals are second best, and are the most consistent group from the standpoint of returns. Third is our small sample of two Financials, followed by two rather eclectic groups, Consumer Goods and Industrial Products. Technology finishes second last, and the "tail-end Charlies" are Retailers.

It is no surprise that Retailers are in last place. It is kind of nostalgic to look at what were considered hot retailing concepts in 1972 – J.C. Penney, K-Mart and Sears. Wal-Mart and the category killers were not even dreamt of at the time, let alone Amazon.com. The leadership of the whole industry has changed over to companies that were either embryonic or not even in existence in 1972. Retailing has no natural barriers to entry.

Our Technology sample is evenly divided between the good and the bad. Xerox and Eastman Kodak, two mainstays of the U.S. technology picture in 1972, both ran into strong headwinds in the 1970s and 1980s, and then stumbled badly in the 1990s. Both of these companies were victims of potent new entrants from Japan: Fuji Film, Konica, Ricoh, Canon, Toshiba and Sharp.

IBM and Texas Instruments both have done better, and IBM has done spectacularly well since 1993, but even if only those two companies were in the sample, the relative ranking of the group would not change. It is remarkable how susceptible the technology markets are to new entrants: Microsoft, Sun Microsystems, Cisco, Dell, Compaq and all the rest were not in existence at the inception of the sample. A sustainable competitive advantage is difficult to build in the technology area.

The Industrial Products group is led by Jack Welch's GE, which has generated the fifth-best long-term return among our 29 stocks. GE is also the only one of the Industrial Products companies whose compound return in the past eight years is substantially higher than its 29-year compound return. Clearly, 3M, Schlumberger, International Flavors and Fragrances, and Dow Chemical are not the businesses they were in the 1970s. But neither is GE – it has exited many of its traditional businesses, and has become a major force in financial services.

Our two Financials companies are an interesting pairing. American Express has a sample average long-term return. Its current vicissitudes in a contracting travel market probably make the stock look worse than it deserves. If we had been doing this survey a year ago, the long-term return would have been 13.4%, and it would have placed much higher in the sample. End date sensitivity has cost the company over 2% on its compound return!

Citigroup is a much different company than the Citibank of 1972, having turned itself from a money centre commercial bank into an aggressive, multi-line financial services company involved in insurance, banking, investment banking, consumer credit and stock brokerage.

Citigroup has been the most adventurous company in the post Glass-Steagall regulatory era, entering new segments of financial services with apparent success. Financial businesses are easy to enter if you pay too much and charge too little. It will be some time before we can judge if the new Citigroup really has a competitive advantage.

In our discussion so far, we have referred often to new entrants and barriers to entry. Barriers to entry are the only long-term determinant of profitability and therefore value. At the Value Investing Seminar at Columbia last June, Bruce Greenwald, the fine professor and practitioner of value investing, made a brief presentation on Professor Michael Porter's "five forces" model of profitability. The model sees industry competition as the prime determinant of profitability, and competition itself determined by the nature of the firm's customers, suppliers, competitors, potential substitute products and new entrants. Professor Greenwald said that the model had four forces too many, and *that only barriers to entry determine industry profitability*. A substitute product is a new entrant, customer or supplier behaviour only matters if they have a competitor to go to, or if the customers or suppliers set up a firm to compete with you. So it follows that the only competitive force that matters is that of new entrants into an industry.

That is the great strength of most of the consumer brands companies. If they define their businesses narrowly enough and resist the temptation to "di-worse-ify," they are extremely difficult businesses against which to set up new competitors. Those companies that stick to their core businesses usually generate superior long-term returns.

Yet within the Consumer Goods group there is a wide variability of returns. Avon has returned only 7.0% compound since 1972, but it is the most successful stock of the group since 1993 under the dynamic leadership of CEO Andrea Jung, who has focused and energized the company. At the other extreme is Disney, which has diversified away from its core theme park and children's entertainment business into merchandising, cruise ships, broadcasting and mass market movie production. Disney's recent performance has been deplorable. Management matters – even the best business can be damaged by an unfocused, empire-building CEO.

A big issue for the Consumer Goods companies today is the greying of North America. For growth, their products have depended on new consumers and new household formation. Both of those commodities have been abundant since World War II, but will be in short supply in the future as the population ages. The implications for the consumer brand companies are clear – they must go where the young people are, hence their interest in Asia and Latin America. It will be interesting to see if they can make the transition.

Barriers to entry have been decisive in the success of the Pharmaceuticals companies over the past three decades. Patents, the burdensome and expensive drug approval process, and the enormous marketing and research expenditures involved in this business all militate against new entrants and in favour of high and sustainable margins. And the medical business, unlike the consumer brands business, gets better as the population ages. The prime consumer of pharmaceuticals is the over-60 age bracket, which will see exploding growth in the next three decades. The major problem the pharmaceutical companies face is that the government is their largest customer and may regulate drug prices if it becomes politically expedient to do so.

The best returns have come from the Sin Stocks. (There's a moral in there somewhere.) Anheuser Busch is a fine company and has a great track record, ranking firmly in the upper half of our sample. It has been the predominant winner in the beer wars in the U.S., developing strong brands and positioning itself as the low-cost producer of beer in America. It has relentlessly focused on the beer business, driving many former national brands out of business. The margins it generates have been far higher than those of its competitors. The combination of focus and economies of scale is a formidable one.

The unchallenged champion is Philip Morris. Its compound return since January 1972 is an astonishing 19.3%. To put it in terms that are easy to understand, $1,000 invested in Philip Morris in January 1972 with dividends reinvested in the stock would today be worth $191,950!

The tobacco industry is a stable oligopoly besieged by lawyers. The industry is routinely reviled in the mass media and in political campaigns. It has seen annual volume declines in tobacco consumption for over 20 years in the developed world. Class action suits abound and settlements are very expensive. The barriers to entry in this industry are insuperable – nobody in his right mind would contemplate setting up a new tobacco company. And that is why the industry is so incredibly, obscenely profitable.

The Big Question

Based on the experience of the Nifty Fifty, how can active owners assess their investments to identify potential problems and eroding business franchises?

Here are some good rules of thumb:

1. Watch out for new entrants, and define the market of your company fairly broadly. For example, IBM has always been paramount in the mainframe computer business, but its problems in the 1980s came from the new minicomputer and personal computer sectors. It recovered in large part by becoming more of a software and services firm. For another example, just when Eastman Kodak was settling into a stable duopoly with Fuji Film, along came digital imaging.
2. Examine the nature of competition in your industry – is it constructive or destructive? A market leader will always avoid destructive competition, but react forcefully to restore discipline when a weaker competitor deserves it. In 1993, Philip Morris was seeing its market share eroded by private label cigarettes offered at very low prices. On "Marlboro Friday," April 2, 1993, Philip Morris dramatically reduced

the prices of its premium brands to compete head to head with the no-names. Many portentous articles were written about the death of brands, and Philip Morris stock sold off sharply. In fact, the prices of no-name cigarettes were swiftly adjusted upwards as order was restored to the market, and Philip Morris stock rebounded strongly. A branded product should always win a price war. But it is wise to avoid businesses like retailing where price wars are a way of life.

3. Make sure that the employees aren't hijacking all the value in the company. Some businesses are naturally run for the inmates, like professional services firms. There isn't much room for public shareholders in those companies. It was almost impossible to create lasting value in technology firms in the 1990s because employee stock options programs were so hugely dilutive to the shareholders' interests. And senior executives in all industries have become accustomed to ridiculous compensation packages, with dire effects on both the real earnings of their companies and on their own behaviour as managers.
4. Beware of managers who don't understand capital allocation. Almost all of our 29 companies have a rather checkered history of maladroit acquisitions and diversification attempts. Very few have added value through acquisitions. Many more have had to beat hasty retreats and refocus themselves around the core business. Most companies eventually produce CEOs who use the free cash flow from the great business to acquire and expand inferior businesses. Such CEOs can do remarkable damage to even the best businesses.

So the essence of wise passivity is to select your companies carefully, then relentlessly monitor them for new entrants, destructive competition, employee rent-seeking and bad capital allocation. But there is another part to the story that would have made life much easier for the investor in Nifty Fifty stocks. That is cautious opportunism.

Caution was not a feature of Nifty Fifty investors. They bought stocks at absurdly expensive levels and paid the price. The average stock in Exhibit 1 was trading at over 37 times earnings and yielding 1.1% on January 1, 1972. In the savage bear market of 1973-1975, all of these companies saw their stock prices decline by at least 50%. At the bear market lows of the mid-1970s, these great companies were selling at knockdown prices. If you had bought a whole bunch of them at that time, and held them until today, your returns would have been amazing. The world would have beaten a path to your door. You would have built up enormous wealth. You would have been Warren Buffett!

How could Buffett stand back from the crazy market of 1972 and wait patiently for his time? It was because he had a frame of reference, and that frame of reference was value. An understanding of value imbued him with caution when prices were high, and spurred him to opportunism when prices were low.

Most of us have heard the old saying: "Talent borrows and genius steals." How's this for genius – select a few of the best Nifty Fifty stocks (Gillette, American Express, Coke) and wait until they are bombed out in a terrible bear market, or retrenching after failed diversification initiatives, then buy them and hold them. While most Nifty Fifty investors are today remembered only by their immediate families, Warren Buffett has become a household name. And justly so – he combines wise passivity with cautious opportunism.

It's an unbeatable combination.

Author: **Richard Rooney, President and Chief Investment Officer**

January 2003

Horse Sense

Jim Grant, the editor of *Grant's Interest Rate Observer* and guest speaker at Burgundy's 2000 Client Day, once wrote in a typically elegant formulation that "the tricky thing about risk is that it is more threatening as it seems less obvious, and less threatening as it seems more obvious." [62] The recent stampede of new income trust listings compels us to make some observations about some less obvious risks involved in these interesting vehicles.

An income trust is a financial security that is used to distribute the cash flow a business generates back to its owners on a pre-tax basis. We applaud the creation of income trusts for stable businesses that have few growth opportunities. As owners of portions of companies via share certificates, we would rather have the cash profits earned by mature businesses paid to us directly than have management squander funds on inappropriate acquisitions.

That said, a caveat that we raised in the November 1997 issue of *The View* is once again in order. In today's low interest rate environment, income trusts are being sold to risk-averse investors who are shying away from low-yielding GICs. Many of the recent issues have been of volatile businesses that are unsuited to the income trust structure. So once again there is a mismatch between the risk preferences of the investing public and the innate characteristics of many income trust investments.

The underwriters and analysts are encouraging investors to value these securities based on the cash flow "yield" that is being paid out to investors. This may seem like a good place to start, until you consider that most of these issues are new and unproven, and the respective management teams are under enormous pressure to maximize their Initial Public Offering price by maximizing the forecasted "yield." The only way to do this is to assume that real expenses, such as the depreciation of fixed assets, are not going to be incurred in the future.

It seems that every new issue prospectus that lands on our desks highlights the difference between an onerous historical depreciation expense and a much smaller level of ongoing "maintenance capital expenditures" necessary to keep the business operating at a steady state. As investors who scour the globe searching to invest in that rare anomaly – a business that needs very little ongoing capital – we find this assertion questionable. In the vast majority of cases, depreciation levels are appropriate over the long haul and companies that pay out their depreciation expense as if it were income are simply liquidating themselves. As we wrote in 1997, "you may be keeping the fire alight, but you're burning the furniture."

Canadian business owners are not the only ones to have noticed the income fund phenomenon. More and more sellers of U.S. assets have come north to flog their businesses to the income-starved Canadian public. When we put the question "Why list in Canada?" to the head of one such U.S. company, his frank answer, "Because I can get a higher price for my business," told the whole story. Generally, when U.S. issuers are attracted to the Canadian market, it is because something is amiss. It's not a canary singing in the mine, it's a Rottweiler barking at your bedroom door. So what is wrong this time?

The cross-border valuation arbitrage works because these American firms figure they can cut out the U.S. taxman. This is achieved by creating substantial amounts of intercompany debt – debt that is both issued from and to the income fund itself on a consolidated basis. This debt generates substantial interest expense for the operating company (and an identical amount of offsetting interest income at the income fund level) that serves to reduce earnings and therefore tax payable for the operating company.

The crux of the tax-avoidance argument is for the income fund's intercompany debt to be considered debt by U.S. federal income tax authorities. Consider this warning in the DG Foods prospectus, which is similar to many others that we have read: "There can be no assurance that the U.S. federal income tax laws and IRS (Internal Revenue Service) administrative policies respecting the U.S. tax consequences… will not be changed in a manner which adversely affects holders of the Units." [63] Furthermore, "there can be no assurance that taxation authorities will not seek to challenge" [64] the tax-avoidance structure of the Fund. Moreover, "if such a challenge were to succeed… it could materially adversely affect the amount of distributable cash available to the Fund." [65]

We suspect that American tax authorities will not stand pat for long if substantial amounts of tax dollars that formerly were finding their way into U.S. government coffers disappear. Put not your trust in princes, especially if you're crimping their revenue streams. Buyers of U.S.-based Canadian income trust assets should factor this risk into their valuation calculations.

And there are other risks. The structure of income trusts puts management in shackles. With an overriding focus on the short-term generation and subsequent distribution of cash flow, flexibility is significantly impaired. True, company executives are less able to blow shareholder funds on aggressive expansion projects. But they are also unable to take advantage of value-creating opportunities. In some circumstances, the long-term success and even viability of the organization may be threatened by the lack of strategic manoeuvring room.

Another key shortcoming of income trusts is reduced financial flexibility. We know that many of these new securities have been sold as "bond-like alternatives," but make no mistake: they are equity in the underlying business, pure and simple. And in any business, stuff happens. If a major customer is lost or a new competitor disrupts the marketplace, a corporation that can retain its earnings is in a far better position to weather the storm than one that must pay out everything except (probably underestimated) maintenance capital.

We would argue that prices of many income trusts currently do not sufficiently discount the risks we have mentioned. But there is another overarching risk that should always be considered – unlimited liability. We wonder how many investors fully comprehend that income trusts in Canada – unlike, say, Real Estate Investment Trusts (REITs) in the U.S. – do not offer the same limitations on liability that a corporate structure gives its owners. One of the great drivers of world economic growth was the invention of the limited liability corporation, where investors can only lose the capital that they put up. Think about how few of us would allocate our scarce capital to a project or firm if there were some threat, however small, that we could be on the hook for losses and liabilities well beyond the amount of our investment.

Here is the standard boilerplate in many income fund prospectuses: "There is a risk (that is considered by counsel to be remote in the circumstances) that a Unitholder could be held personally liable for obligations of the Fund (to the extent that claims are not satisfied by the Fund) in respect of contracts that the Fund enters into and for certain liabilities arising other than out of contract including claims in tort, claims for taxes and possibly certain other statutory liabilities." We agree that by holding the Fund's operating assets within corporate structures or limited partnerships, the likelihood that income trust investors could face unlimited liability is remote. But as we have repeatedly discovered in the 1980s and 1990s, remote does not mean impossible, and unlikely events transpire with surprising frequency. Just ask one of the former "Names" of Lloyds of London for his or her opinion on the subject of unlimited liability.

The flood of new listings of low-quality income trusts in 2002 should be enough to make any investor suspect that problems are just around the corner. Chippewa tribal lore relates that when you find you are riding a dead horse, the best strategy is to dismount. Investors who haven't been looking at the less obvious risks should be loosening the saddle girths on their income trust investments.

Prior Claim

As shareholders of corporations, we are owners of the residual portion of the wealth a company generates. If you look at net income available to shareholders, it is something that exists only to the extent that all those other people higher up on the income statement allow it to exist. And over the last two decades, events have conspired to make it very pleasant to be a shareholder.

Just look at the lines of the income statement and think about how those various expense categories have fared since 1982. First, cost of goods sold. Commodities have been exceptionally well-behaved, with very few of the fierce price spikes that characterized the 1960s and 1970s. Direct labour cost inflation has been kept in line by a combination of harsh headcount reductions and the rise of new, low-wage manufacturing bases overseas. Job cuts have also kept selling and administrative costs down. Interest costs have fallen steadily over the entire period and tax rates have generally been reduced. So the residual, not surprisingly, has grown over that period at a rapid rate.

But it didn't grow as rapidly as it seemed to. The national accounts estimates of earnings for corporate America peaked in 1997 and were flat to down thereafter. Yet the numbers that corporate America reported to its shareholders continued to clip along at 10% growth rates until 2001.

Obviously, accounting games were being played. As management became more and more vitally interested in the accounting numbers due to their compensation structure, they brought to bear more and more pressure on accounting standard-setters to retain questionable practices – like pooling of interests accounting for mergers and not expensing stock options – and to set up new approaches that allowed them to manipulate net income, such as the FAS 87 rules for pension accounting.

The pension rules were instituted in the mid-1980s. The rules responded to two major concerns of American managers. First, they did not want to show their pension assets and liabilities on their balance sheets, since these can be very large amounts. Second, they wanted the pension expense number to be manageable, and not introduce a high degree of volatility into the net income calculation. They succeeded on both counts.

Let's agree right up front that a place where actuaries, accountants and government tax rules meet is going to produce some pretty complex accounting. But simply speaking, there are two parts to the pension puzzle. There is the funded position of the pension plan, which is the amount the company would have to contribute to or withdraw from the pension fund in order for it to equal the estimated present value of the plan liabilities. And there is the pension expense, which is an attempt to measure the amount by which the company's pension liability has increased in a given year. We will talk about the funded position first.

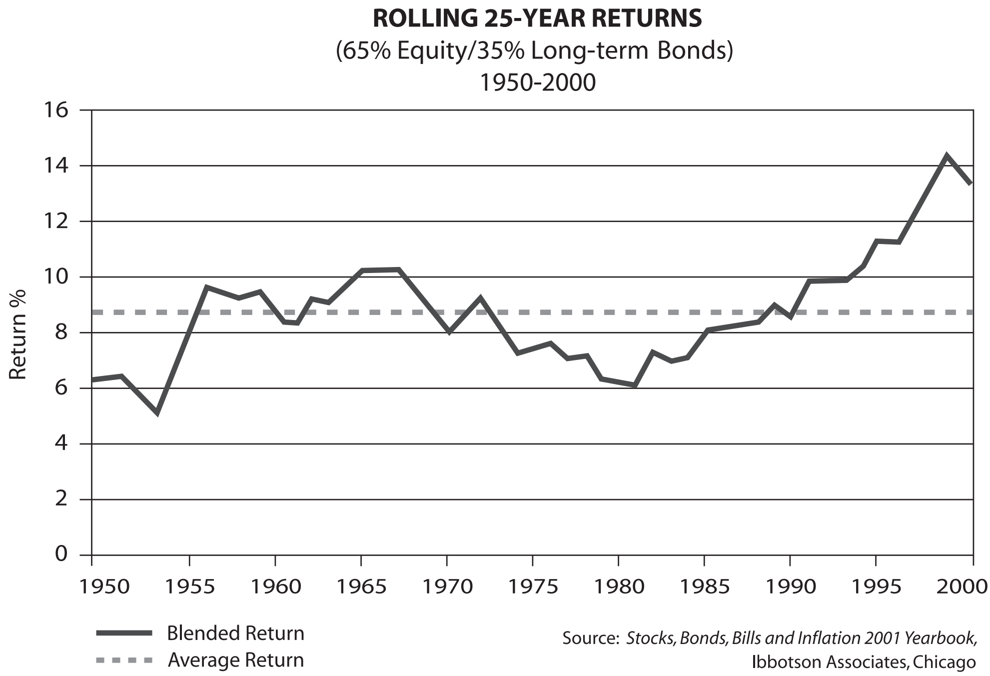
Any company that has a defined benefit pension plan has a liability that exists sometime in the future. The size of that liability varies according to the size and age of the workforce, its rate of pay increase, its longevity and so on. Actuaries estimate this liability based on intricate mathematical models and projections. Companies (unlike governments) are not allowed to have an unfunded future pension liability, so they set aside funds on a systematic basis to offset this liability. Those funds are invested in financial assets.

The liability grows steadily and predictably most of the time. But the asset (the actual pension fund) is prone to prolonged spikes and swoons as the returns in the markets ebb and flow. There is, therefore, an ongoing mismatch between the size of the liability and the size of the asset, resulting in overfunded or underfunded positions. A company with a large unfunded pension liability has a large call on its capital resources sometime in the future.

When the plan is overfunded, companies can take payment holidays and reduce or eliminate their pension expense on a temporary basis. In some circumstances, companies can even show profits from their pension funds. For some major companies, like GE, IBM and certain telecom companies, those rather suspect "profits" represented a significant portion of total reported net income in the late 1990s.

This brings us to the pension expense. The pension expense consists of three basic parts. These are the annual increase in pension liability caused by the unwinding of the discount rate, the addition to the liability caused by the addition of another year's service by the workforce, and the offsetting assumed rate of return on pension fund assets. Note that the expense is presented on a net basis – it incorporates both expenses based on the pension liability and an income stream based on the pension asset. Note also that the income stream is highly notional – it is an assumption rather than an actual return from the fund in the fiscal year. The return assumption is entirely subject to management's control. If you increase the assumed rate of return on your pension fund assets, you reduce your pension expense and increase reported net income. So it should come as no surprise to anyone who is familiar with the mores of corporate America that almost all companies use too high an assumed rate of return on their plan assets.

To be fair, that problem is partly the legacy of the extremely high returns on financial assets in the 1990s. All trailing series of returns in the capital markets suffer from end-date sensitivity. What is surprising is the extent to which even a long-term return can be affected by recent strong performance. Looking over the 25-year trailing returns from 1950 on, it is clear that the returns from the late 1990s are an historical outlier of major proportions. The following chart shows the blended return on a portfolio that is 35% bonds and 65% equities.



All observations from 1994 until 2000 are higher than any previous numbers. Including these years, the average of fifty 25-year return numbers is 8.8%, not far off the 9.2% average of all pension return assumptions for S&P 500 companies. But excluding the last six years, the average falls off to only 8.2%. And these numbers do not include the poor returns of 2001 and 2002 from the markets. A glance at the previous chart shows a very disturbing tendency for these returns to revert to much lower levels after periods of unsustainably high returns.[66]

Of the 360 companies in the S&P 500 Index with defined benefit pension plans, only 30 had return expectations less than 8% in 2001. Only seven were lower than 7%.

And 58 companies assumed that their entire pension fund would be able to compound at over 10% in the long term – almost equal to the historical expectation on a 100% equity portfolio.[67]

Regrettably, even the highest-quality companies have indulged in these practices. Only one company in our current U.S. equity portfolio has an assumed return of above 10%, but nearly all the others are in the 9-10% range. And these return assumptions must be reduced as the reality of lower returns strikes home.

How will the necessary reduction of assumed pension fund returns affect reported profits in the next few years? Well, the median rate of assumed return on corporate pension funds is currently 9.2%. If that rate is dropped by 1%, the impact on corporate earnings of the 360 S&P 500 companies with defined benefit pension plans is estimated to be $10 billion in annual pension expense. The ongoing level of GAAP earnings on the S&P 500 would be reduced by about 2%.

A few years ago, the SEC specified the use of a specific type of discount rate for plan liabilities in response to accounting games being played by corporate managements. It looks like it is time to remove games-playing opportunities from the asset side of the pension fund balance sheet as well. Mandating the use of long-term returns from the Ibbotson Associates reports or another authoritative source as a maximum acceptable rate of return assumption would be a good start. As we have seen, that alone would force most companies to reduce their current untenable assumptions.

A better answer than playing with assumed pension returns would be to scrap the current system of pension accounting and unbundle the pension expense. Report the actual level of plan returns in one place on the income statement and the calculated level of expense in another. Companies will respond that such a treatment will lead to highly volatile earnings reports. But after the past five years of chicanery and deception, does anyone really believe that giving managements the discretion to smooth their income is a good idea? It's time to end once and for all the ridiculous conceit that anything as complex as a large company's comprehensive net income can grow at fixed increments over a long period of time with little variability.

In the final analysis, the pension expense is so notional that it does not really reflect corporate capital allocation.[68] What drives the capital allocation process is the level of unfunded liability. And those liabilities are ballooning throughout the defined benefit system. As we mentioned, the pension liability has something inexorable and inevitable about it – it grows slowly but surely over time. We have often rhapsodized about the power of compound interest when applied to an appreciating asset. Just as powerful and very frightening is that same compounding applied to a major liability. And when the offsetting asset is not keeping pace, the net liability position can quickly become a threat to the business.

Huge pension surpluses have already been wiped out in only a couple of years of poor market performance. Nortel, for example, had a pension overfunding of over $900 million in 1999. As of 2001, that had become a $1.6 billion unfunded liability. And given the returns in 2002, we would expect further bad news here. A couple more years of bad returns in corporate pension funds will allow these liabilities to outstrip the offsetting assets by a frightening amount.

Many companies will have to come up with very large capital contributions in order to offset these major unfunded pension liabilities. That capital, in turn, will not be available to increase dividends, buy back stock or invest in new opportunities. It is a new age – one where management is much more capital constrained, and one where shareholders are going to have to be intensely aware of the prior claims on the cash flows and assets of their companies.

Author: **David Vanderwood, Vice President and Portfolio Manager for Canadian equities**

June 2003

Rooney's Believe It or Not

Richard Rooney, the President of Burgundy, delivered the following speech on the Firm's Client Day, May 13, 2003.

I'm sure when you opened your first-quarter report you had a moment when you thought (among other things), "I wish I hadn't been in stocks last year." And the shorter your experience with our company, the worse you felt, because we have not generated strong positive annual returns since the first quarter of 2002. The fact that very few long equity managers in the business did better, and that your managers shared your pain by being invested alongside you, is cold comfort at best. And you felt even worse when you heard about how some of your friends did last year.

One of the perennial features of being an investor is that you are always running into people who did something bold and imaginative with their investments, and who made more money than you did. This morning, I'd like to examine some of the ways that your friends may have done better than you did in 2002. I want to think through the logic behind those investment approaches with you, and ask if you believe that logic still holds.

There is a field of study called behavioural finance that examines how people actually invest. Behavioural finance shows that people at one and the same time overestimate the returns they will receive on an investment, but compensate for that optimistic bias by almost never making bold moves with their money. For example, almost everyone accepts that equities give higher long-term returns than other asset classes. And despite this belief, almost nobody has all their money in equities all the time. So bold and decisive moves in investing are extremely rare, and the people that say they liquidated their holdings and went into another asset class in 2002 are probably not telling the whole truth. They probably did something, but just enough to feel good about.

What were some of the things people could have done in 2002 to feel good about? Well, in increasing order of risk, they could have stayed in T-bills, bought bonds, bought income trusts, bought gold stocks, bought hedge funds or sold their equities planning to re-enter the equity market at a later date.

When you make any of these moves, you are saying you believe something about the world. Let's think through what those beliefs are, and you can decide whether you share them sufficiently to put your hard-earned money on the line.

I. Stay in T-bills

The most risk-averse strategy over the past year has been to stay in T-bills. Sure the yield was lousy, but the satisfaction of not losing money was pretty high. The behavioural finance people tell us that a loss is over twice as painful as a gain is pleasurable. So you may feel a pleasant glow of satisfaction when you see a 10% or 15% positive annual return, but you feel a 15% loss like a kick in the stomach. I know I do.

T-bills have the great advantage that they are relatively deflation and inflation proof. If the economy deflates, you get your money back, while if it inflates, your yield follows inflation up, with a lag.

But at current yields, if you stay in T-bills, you are saying you believe that the risks in the capital markets and the economy are so great that you are willing to sacrifice almost all possible returns for capital safety. Do you believe this, or not?

If you had a lot of cash in the last year, congratulate yourself, tell your friends about it and by all means exaggerate. But remember, what worked last year, especially with an extreme strategy like going to cash, will probably not work two years in a row.

II. Buy Government Bonds

With the economy floundering in 2002, bonds did pretty well, giving you a blended return of about 9%. Yields are down to lows not seen since the 1960s.

But if you own only government bonds at these yield levels, you are making a one-way bet on deflation. With the sole exception of the last decade in Japan, there has been no period of deflation since the gold standard was abandoned in 1945. Warren Buffett claims that inflation is only "in remission because of the human nature of legislators." [69]

Inflation is murder for bondholders. When I started in this business, after the great inflation of 1966-1982, bonds were still often referred to as "certificates of government confiscation." So, do you believe in deflation, or not?

As with treasury bills, the return sacrifice from going into bonds could be significant. Collecting a 5% taxable coupon is a tough way to compound your capital. Even with quite conservative assumptions, equities should do better than that, especially after tax.

III. Buy Income Trusts

Income trusts appeal to people who see the derisory returns from T-bills, bonds and most equities, and look for alternatives. Burgundy has become identified as being against income trusts on principle. In fact, we think they are a great idea for the very limited number of companies that can sustain their payouts for the long term.

But the factors that will enable income trusts to sustain higher yields are exactly the same ones that will drive the stock market. Income trusts are essentially just calls on corporate cash flows, and so you need growth in the economy and growth in corporate earnings to keep them paying out those cash flows.

If you own income trusts rather than equities, you must feel income trusts are a better structure than a share capital corporation to deliver returns to shareholders. Do you believe that, or not?

The returns on income trusts currently look pretty attractive relative to what is available in traditional yield investments like bonds, treasury bills and preferred shares. The problem is that the class is very heterogeneous and has a short track record. So nobody knows what to expect. In our view, high-quality common stocks should outperform income trusts over the long haul because, as an asset class, their performance characteristics are a known quantity.

IV. Buy Gold Stocks

As the only monetary asset that is not someone else's monetary liability, gold has a unique position in finance. I feel that if I really understood the psychology of gold investing, I would be so wealthy that I would be listening rather than talking at functions like this. As you can see, that is not the case.

Investing in gold equities is a hedge against monetary inflation and global catastrophe. But valuations of gold stocks are usually so high that it is very difficult to justify them without resorting to dubious methods.

If you own a lot of gold stocks, you are betting either that the government will print money and cause inflation, or that the world financial system faces complete collapse. Do you believe that, or not?

From a returns standpoint, gold equities are volatile performers, and are world-beaters only about one or two years out of every decade. After a huge run since September 11, the group has probably had its day for a few more years.

V. Buy Hedge Funds

From a fringe industry 10 years ago, hedge funds have now become mainstream for many institutions, and are gaining market share with individual investors as well. The fact that just about anything can be designated a hedge fund has perhaps obscured the original purpose of these products. The concept of hedging is, according to my dictionary, "to protect oneself from losing or failing by a counterbalancing action." [70] This implies that a true hedge fund would not be a return maximization vehicle, but rather a risk management vehicle. Most of the ones I have seen that sell to private investors do not look like that. Most of them are taking big risks.

The risk they have usually been taking is selling short. Selling short is a scary process. Your return is capped at 100% since the most you can make by going short is the price at which you sold the stock. On the other hand, if the stock you have sold short goes up in price, your losses are potentially unlimited. So to us, the risk/return tradeoff is against the short seller. Nevertheless, since the spring of 2000, it has been almost impossible not to make money by shorting stocks. And if it's impossible not to make money doing something in the capital markets, financial people will be attracted to that activity like vultures to carrion, and the public will flock to it like sheep. Note my different similes.

There are now more than 6,000 hedge funds in North America, up from perhaps 500 a decade ago. The fee structure that is charged is extremely generous and sometimes extortionate. These managers are generally not held to any benchmark absolute return and they take home 20% or more of the total pre-tax return on their clients' funds. Disclosure is usually minimal and regulation, especially of offshore-domiciled products, is non-existent. Track records of longer than three years are rather rare.

If you put all your money in hedge funds, you must believe that this new and opaque investment category can earn outsize returns without outsize risks. Do you believe that, or not?

There are many capable hedge fund managers around. But for every good one, there are probably a dozen bad ones, and for every careful and well-executed strategy, there are likely a dozen high-risk ones involving short exposure. This area is new, underregulated and lacks transparency for investors. Caveat emptor.

VI. Sell Stocks and Get Back In Later

Once in a while, you meet someone who claims they successfully timed the market. As my previous remarks about behavioural finance will indicate, you should be skeptical about their claims. But you should be even more skeptical about their strategy. Of all the ways to use the stock market, market timing is the most risky and most likely to lead to foregone returns.

If you are going to invest in common stocks, you must invest in them continuously. In the long run, the market tends to recognize the appropriate value for a company. But there are large leads and lags in the process, and value is recognized on a shockingly small number of days.

Nicholas-Applegate surveyed the 10-year period from January 1, 1983 to December 31, 1992. Over this period, there were 2,526 trading days. The compound rate of return on common stocks was 16.2%. If by poor market timing you missed just the best 40 days of that market, and had been fully invested for the other 2,486, your return would have fallen from 16.2% to 3.6%. Those 40 days, 1.6% of the trading time, accounted for 78% of the returns.

To sell equities and look for a later re-entry point, you have to believe that you can successfully time the market. Do you believe this, or not?

The stock market climbs a wall of worry. By the time the risks disappear, the returns will have already been realized. Getting out of the market in order to get back in is a loser's game.

VII. Buy and Hold a Diversified Portfolio of High-quality Common Stocks

This is the strategy that most people in this room have followed over the past several years.

The reason that common stocks are so unreliable as a short-term source of returns is that they cannot adapt instantly to changes in the economic environment. But the reason that they are so reliable as a long-term generator of returns is that they can and do adapt to long-term trends in the economy. They are human institutions. That means they are prone to make mistakes. It also means that they are resilient and amazingly adaptable. A couple of years ago, we put out an issue of *The View from Burgundy* that updated the Nifty Fifty growth stocks of the early 1970s. Lo and behold, the great majority of these companies had delivered outstanding long-term returns to their shareholders for more than 30 years. Think about the challenges these companies faced over that time frame. Oil shocks, stagflation, fluctuating currencies, brutal monetary disinflation, interest rate spikes, stock market crashes, recessions, booms, bubbles and September 11th were all included in the measurement period. And shareholders made money. They didn't make it in a straight line, they weren't always above water, but they earned strong returns, especially from businesses with high barriers to entry.

We think that this is the ultimate argument for owning stocks in good companies. They have survival instincts, they have mind and management, and they can adapt. The adaptation process may not be immediate, but it is reliable and effective. None of the other strategies offer this feature. Bonds and treasury bills are, in the last analysis, only fixed streams of cash flows. Gold is a commodity, albeit an odd one. Nobody knows what hedge funds are. Companies are living organisms – active rather than passive investments. They alone of these investments have the capacity to learn and to grow.

And the investment environment, unlike the economic environment, is better today than it has been in many years. During the 1990s, there was a huge abdication of responsibility by those who are supposed to make the capital markets function. Auditors and accountants forgot their obligations to shareholders and became doormats and sometimes accomplices of managements. Boards of directors likewise forgot themselves, often because they were aligned with option-holding managers rather than shareholders. Managers indulged in accounting and share price manipulations, and even fraud, due to corrupt accounting and grossly misguided incentive systems. In a political environment of deregulation and laissez-faire, regulators were starved of funds, and had great difficulty keeping up with advances in financial technology. Money managers were too busy taking personal credit for returns generated from a runaway stock market to look after the interests of their own clients.

In other words, shareholders had few real friends in the 1990s.

Today, by contrast, everyone is trying hard to be on the side of the shareholder. Accountants, horribly embarrassed and ashamed by the events of the 1990s, are more likely to stand up to corporate pressure than at any time in history, since the future of their profession depends upon it. Regulators are getting more funding than they ever have, and will put more resources to work. Many businesspeople lament the increased regulatory scrutiny, but when the system proves that it cannot be trusted to produce equitable outcomes, increased regulatory activity is both inevitable and desirable. Managements are fighting a rearguard action against these changes, but it is clear that the golden age of options and share price manipulation is over. And shareholders are finding champions among money management organizations.

An example is the Canadian Coalition for Good Governance. We believe that this watchdog will help protect shareholder interests in Canada. It has a potentially huge role to play in advocating shareholder-friendly policies to accounting standard-setters, regulators and legislators. It is also not afraid to pick a fight when management strays from the straight and narrow. And other such organizations have sprung up in other countries.

So the system is much more vigilant against fraud and manipulation than it was in past years. And you have the adaptive qualities of equities on your side. One last building block has to be in place for us to get excited about equities. That is value.

There is a pretty good story here as well. You have no doubt seen the articles lamenting how expensive the stock markets are today. The S&P 500 sells at 27.4 times next year's earnings, and 3.5 times book value, yielding only 2%. That is quite true. Fortunately, we do not invest in the S&P 500 Index. The blended price-to-earnings multiple of our portfolio in the U.S. is about 17 times on next year's earnings. The vast majority of the overvaluation in the market is in the technology sector, where multiples are sky high after the recent rally. And our exposure here is minimal. We have recently been able to buy really good companies on sale, and that is good news for future returns. And this is true in all markets where we invest, whether the U.S., Canada, Japan or Europe.

Our approach of owning a diversified portfolio of good companies in the world's major markets, with bond and money market exposure tailored to your circumstances, will work better than any of the extreme moves that gave your friends bragging rights in the last year. In equity investing, as the present darkens, the future brightens. Three years of bear market declines have produced some good value among the reliable, well-managed companies we like to invest in. The regulatory and governance framework has been repaired and will function better than it has in many years. And you have the ace in the hole – the superb adaptive capabilities of public corporations are on your side to build wealth through share ownership. So despite or because of a sloppy world economy, despite or because of the world political situation, despite or because of the three-year bear market and the universal dislike of equities as an investment class, as a diversified equity investor, you are better off today relative to the investment alternatives than at any time in the past decade. Believe it or not!

Author: **Richard Rooney, President and Chief Investment Officer**

September 2003

A Record of Failure: Fund Managers as Shareholders

The following speech was delivered by Richard Rooney, the President of Burgundy, to the Ivey Alumni Society of Toronto, on June 18, 2003.

About four years ago, I gave a speech to the Canadian Institute of Chartered Accountants' Financial Reporting Conference in which I examined the role of the auditor and accountant in the late 1990s. The way I framed my argument was in terms of lines of defence for the shareholder. According to that metaphor, the Board of Directors is the first line of defence, followed by the auditor. If neither the Board nor the auditors are doing their jobs, then the final line of defence is the securities regulator.

Something always bothered me about that description. In the aftermath of Enron and Worldcom, I figured out what it was. The unspoken assumption of my speech was that the shareholders were like the fair maiden tied to the train tracks by a 1920s silent movie villain – objects of considerable sympathy, but not actors in their own fate. Yet shareholders are not some amorphous mass – shareholders are represented to a very large degree in the public markets by large, highly profitable and powerful investing organizations – the money managers. These organizations should operate as another line of defence for shareholders, rather than relying on the timely arrival of the cavalry to thwart the villains.

After the big party of the 1990s, most capital markets' participants have been well and truly pilloried. Most are coming under tough new regulatory regimes. Accountants are subject to severe new rules about doing non-audit work for audit clients, and have new oversight bodies to examine independence issues. Boards of Directors are under intense scrutiny about those same issues of independence and conflict of interest. Future managements are going to have to deal with all the red tape from Sarbanes/Oxley and its Canadian variants. Yet the professional money managers have skated through the controversies of the past few years without serious damage. Although they were masters of the universe on the way up, eagerly touting the qualities of the stocks their clients owned on CNBC and ROBTV, somehow they contrived to be victims "just like you and me" on the way down. This is not a credible claim. The fact is that money managers had at their disposal the means to help the system cope with the problems of the last decade, and failed to take advantage of those means.

Unfortunately, the reason that happened is part of the DNA of the investment management business. This morning I would like to walk you through a survey of the structure of the investment business to identify the balance of power between the corporate sector and the money management industry. We will see why money managers have been ineffective and reactive in looking after the shareholders' agenda. We will conclude with some suggestions on how that agenda might be better protected and advanced. The key points are that money managers must exercise the powers and prerogatives they already possess, must be willing to invest time and money in collective action to negotiate directly with corporations, and must help to build a better functioning infrastructure for the capital markets. The current road of waiting until an atrocity happens and then letting the regulators and politicians deal with things is not good for business, and will reduce long-term returns if management's ability to manage is compromised.

Investment Agendas

Let's look at the investment industry. The primary division in the investment business is between the buy side, or investing organizations, and the sell side, or brokerage businesses. As the buy versus sell title would indicate, there is an adversarial nature to this relationship. The buy side and sell side are intermediaries for their respective constituencies. Investing organizations represent the consumers of financial products and information, while brokers represent the producers. So behind the buy side is the general public in various degrees of aggregation, while behind the sell side is the corporate sector. Let's look at the agendas of the two main constituencies.

The corporate sector's agenda is quite simple and uniform across companies. At the highest level, their primary purpose in the capital markets is to minimize their cost of capital, which they do by sustainably maximizing the prices of their publicly traded securities, such as stocks and bonds. They have two main weapons in attempting to reduce their cost of capital – control of information about their company's performance and prospects, and control over the timing and distribution of financings. Over the past two decades, a low cost of capital has become not just a source of competitive advantage for companies but a matter of survival, since in the absence of a control block, a perennially low stock price and inefficient capital structure will attract acquirers like flies to honey.

That leads us to corporate management's other main objective, which is survival. This objective can be reached through two means – management can entrench itself, and management can enrich itself. Most managements will want to do both. Entrenchment can take place through staggering the terms of the Board of Directors, requiring supermajorities on the Board to approve takeovers, or passing a so-called shareholders' rights plan to strengthen management's hand if management doesn't approve of a potential acquirer. Enrichment has usually taken place through the fixed price option grant and the huge severance package, or golden parachute.

So the logic of management's position is that they must impress their shareholders so they get a low cost of capital, and then persuade their Board that this impressive management deserves large financial rewards and job protection. The great majority of managers do it the old fashioned way: by executing for the shareholders. Those people deserve to be generously rewarded. But the wrong kind of incentives can lead to this agenda being hijacked by the Ken Lays and Bernie Ebbers of the world.

Let's stop a moment and consider how a rational business owner should respond to this agenda. Presumably the quest for a low sustainable cost of capital is an area where shareholder and management agendas dovetail. The difference may well be in the word "sustainable." A business owner would never resort to short-term accounting tricks to artificially raise the price of his stock – he'd only be fooling himself. He would see to it that the incentive system did not encourage such games. And he would take care to see to it that his managers didn't get filthy rich at his expense. Ideally, management would get rich the same way he would – through long-term stock ownership.

Clearly, given the success of many corporate managers in the past decade at self-enrichment and short-term stock price manipulation, the shareholding public, the other major constituency, has not embraced the approach of the rational business owner. What is the public's agenda?

The investing public is not very coherent in the way it addresses the markets. Given a clear and mutually exclusive choice between safety of capital, growth and income, the public will invariably want all three. Some of them will also want to address social, ethical and health concerns through their investment choices. And they don't want their investments to perform badly, and they reserve the right to define poor performance in either absolute or relative terms. All this adds up to a rather fickle and distracted constituency that wants it all and wants it now.

This incoherence is fully reflected in their intermediaries, the money managers. We can perhaps express the problem of money managers as shareholders in the form of a general proposition – the more choice and discretion the public has over its investment vehicles, the less likely the money manager is to have the staying power to deal with management's agenda as rational business owners, and the more likely money managers are to concentrate on short-term performance and immediate issues. Conversely, the more locked in the public is, the more the money manager can afford to look at longer-term issues of Board effectiveness, compensation programs and accounting clarity. So there is a hierarchy of effectiveness in corporate governance based on the permanence of the manager's investor base. That hierarchy also applies on the basis of the permanence of the investments a manager holds. Clearly, if the time horizon of the investor is long, he will be more concerned with the long-term health of his company than with short-term noise. But in practice, money managers spend far too much time making meaningless trades, and far too little time thinking about the long-term health of investee companies.

At the bottom of this hierarchy are the investment counsellors and mutual fund managers. They tend to be relatively small and active players. This means that they trade in and out of stocks, and do not have to own anything. They often invest according to the Wall Street Rule: If you don't like it, sell the stock. They are therefore less inclined to stand and fight on long-term shareholder issues. Another bar to their effectiveness is conflicts of interest. They often have large corporations as pension fund clients, and when one of those clients tries to put one over on its shareholders, there is a tendency to put the business interests of the money manager ahead of the interests of the shareholders. Finally, there is ferocious competition among investment counsellors and mutual fund companies. This competition can lead to some really counterproductive behaviour. For example, superior insights about ropy accounting or bad governance can be considered a source of competitive advantage, giving the money manager an interest in their continuance rather than their elimination. And even if a manager does care about shareholder issues, but sees that a competitor is already spending time and effort on them, he can take a free ride on the competitor's efforts.

Most effective and formidable in the corporate governance arena are the big public pension funds. They are large pools of captive capital that are so huge they will end up owning everything in the market, and owning it long term. Since they are in for keeps, they have a large vested interest in improving the effectiveness of their investments and making their opinions heard. Due to the reasonably homogeneous nature of their client base, outfits like Ontario Teachers and OMERS (or in the U.S., Calpers and TIAA-CREF) have fewer conflicts of interest than most money managers. If you wondered why they've been at the centre of so many corporate governance initiatives over the years, there is your answer.

Mobilizing the Buy Side

There are a lot of barriers to joint action by buy-side organizations. One you may not have heard of is the concert party legislation, which made it illegal for shareholders to co-operate against management except in the context of a full out proxy fight. So until recently, it was actually risky from a legal point of view to have anything more than an informal discussion of common interests with another shareholder. I think that was more often an excuse than a reason, but as excuses go, it was a pretty good one. Since that legislation is no longer with us, the excuse is gone as well.

Different agendas and organization structures are another barrier to co-operation. Some large organizations have very involved Boards of Directors that do not allow the subcontracting of issues like corporate governance advocacy to others.

Internally competitive, often conflicted and with actual disincentives to co-operate in place, the buy side is in a bad position to confront the purposeful and self-interested corporate sector. The implication is that the buy side will always be reacting to events rather than pro-acting. That is a pretty good description of the buy side as I have known it over the past 19 years.

Well that is all pretty depressing. But it's not all bad news from the buy side. Because the fact is, things are looking up. Some good things are happening in corporate governance land.

The money management industry can be quite effective when it rallies around a single issue with a finite goal. We saw that with the debate over expensing employee stock options, though fanatical management resistance in the U.S. has prevented that issue from being put to bed even now. Right now I think there is an emerging consensus to oppose excessive executive pay, especially golden parachutes, with shareholder opposition appearing in the U.S., the U.K. and Canada. Obviously these single issue advocacy situations should be handled with care – the management compensation issue is less cut and dried than the stock options accounting issue and must be dealt with on a case by case basis. Fortunately, as with stock options, Canada has not reached the level of shameless troughing that U.S. corporate managers have achieved.

What is needed is a rallying point for the industry, and that is what I believe the Canadian Coalition for Good Governance (CCGG) is going to be. Given the constraints on the various players on the buy side, it would be too much to expect that everybody will be able to join this organization, which was founded late last year. About 20 large Canadian institutional investors have done so, and a large number of others are associate members. I should declare a conflict here, since Burgundy Asset Management is a full member of the Coalition and our Chairman, Tony Arrell, is on its Board of Directors.

I feel certain that the CCGG can establish itself as a great source of information for concerned shareholders and as an advocate for shareholder-friendly reforms in Canadian companies. The intention is that the Coalition will work quietly and consistently toward a set of goals for Canadian companies to achieve. These goals will in no way interfere with management's right or ability to manage the company for maximum return, but will ensure that the institutional framework is in place for shareholders to act like rational business owners and get value for money from their management teams. Under the leadership of David Beatty, an experienced director and businessman, and Michael Wilson, a deeply respected industry executive and former Finance Minister for Canada, I am confident that it will be a quietly effective negotiator and a great focal point for corporate governance activities in Canada. In time, given good support and continued involvement of good people, the CCGG will gain its own institutional identity and become, we hope, a fixture on the Canadian investment landscape.

Next Steps

So in terms of single issue advocacy and negotiating the governance agenda with Canadian public company managements, the money management industry seems to have learned a thing or two in the last couple of years. Better late than never. We have gotten to know one another better and have done some useful work for shareholders. But there remains one area where we could and should be doing a much better job. We should be investing in the infrastructure of our industry, especially in matters like accounting standard setting. Our lack of involvement here is unforgivable.

Let me give you an example. On March 4, 2002, Claude Lamoureux of the Ontario Teachers' Pension Plan gave a speech to the Canadian and Empire Clubs entitled "Corporate Governance – Time to Get Serious." It was an excellent speech and I rarely find myself at odds with Claude on these matters. But among the 11 very sensible recommendations that Claude made, one was phrased in a particularly revealing way. Number six said, and I quote: "Canadian regulators should work with the CICA to promote the best accounting standards... as opposed to the least offensive."

The clear implication is that money managers are takers on matters of accounting standards, and that the regulators must look out for our interests in this vital area. That is a widespread opinion among buy side people. Yet the standard-setting process is designed to give financial statement users such as investors as much direct input as they wish to give. I'll go further – the standards setters worldwide are begging for engagement by the investment industry, and getting very little co-operation.

After Worldcom, Enron, Tyco and the fall of Arthur Andersen, anyone who uses financial statements has to believe that accounting really matters. Yet the Canadian money management industry ignores its own standard setter and lets its industry association, the Association for Investment Management and Research (AIMR), deal with the CICA's Accounting Standards Board whenever it has the time. Don't get me wrong, AIMR's advocacy group does a good job, but in the last analysis they are an American organization and it's not their day job.

There are great advantages to our industry helping our own accounting standards setter. There have been differences with U.S. GAAP that have benefited Canadian investors greatly. Pooling of interest accounting on mergers, for example, was never allowed in Canada, and that was one of the several very poor U.S. GAAP treatments that helped expand the bubble in the U.S. The Canadian Board came out in favour of options expensing last October, while in the U.S., the Financial Accounting Standards Board (FASB) remains tied up in political knots on the subject. Our industry could make great use of the Canadian standards-setting process to push an international agenda, since the Canadian Board is one of the world's most respected standard setters and has substantial influence with both the FASB and the new International Accounting Standards Board (IASB).

The corporate sector takes great care to ensure that its interests are represented in the standard setting process. Shouldn't the money management industry present the investor's perspective?

This is an area where the new Canadian Coalition for Good Governance could do some useful work. It is already undertaking some initiatives here, but in my opinion there should be a full-time employee from the CCGG on the Accounting Standards Board who can represent the shareholder's interests in standard-setting and alert the industry to issues arising from proposed new standards. As we have seen repeatedly over the past three years, accounting standards on things like options expensing and Special Purpose Entities are meaningful both financially and behaviourally.

I'm sure that there are other opportunities for the buy side to invest in a better framework for the capital markets. If we were to ask regulators and corporate managers the ways in which activist money managers could benefit the system, we could probably get a pretty interesting list. I simply chose accounting to concentrate on because it's something I know a little bit about.

So that's my survey of money managers as shareholders. It's a history of pretty poor performance, but I hope you agree that there are grounds for optimism.

Some of you may have expected a broadside against money managers and all their works in today's speech. Others may have wanted to hear some good hard fixes for what ails the capital markets from a money manager's viewpoint. I fear I have satisfied neither party. Quick fixes are not going to help us at this point. What is needed to restore lasting confidence in the system is a return to an old-fashioned idea stewardship. It is needed in corporate offices, in boardrooms, in accounting firms and in money management organizations. The public has entrusted us with their money and we must do our best to represent their interests. The old definition of the duties of a money manager as simply to provide competitive returns, while necessary, is no longer sufficient. We must remember that all financial businesses are based on public confidence, and public confidence has been badly shaken by the events of the past three years. In order to help restore public confidence, the money management industry is going to have to do some investing – in its own credibility.

Author: **Richard Rooney, President and Chief Investment Officer**

February 2004

The Eighth Wonder

In recent years, some new members of the Burgundy investment team have begun to find their voice through The View from Burgundy. *David Vanderwood wrote this analysis of the checkered history of capital allocation at BCE, one of Canada's flagship companies. He also worked in a theme that gets entirely too little attention – the supremely important nature of compounding and the radically damaging nature of negative returns.*

Richard Rooney, 2007

On a cold Montreal day in February 2000 at BCE Inc. headquarters, Jean Monty was making a tough decision. As head of the dominant local telephone company in eastern Canada, Mr. Monty felt like he was in a box. His business, while generating huge cash flow atop a natural monopoly, was a mature one. His shareholders, at least as he understood them, wanted growth. So, what to do?

The question was made even more challenging by BCE's track record, where prior attempts to jump-start growth via diversification had ended painfully. In 1989, the corporation bought a controlling interest in Montreal Trustco Inc., only to take a $500 million loss on selling it to the Bank of Nova Scotia in 1993. In that same year, management had also presided over the sale of BCE's interest in Brookfield Development Corporation. This involved a $700 million write-off of another blunder from the 1980s.

Mr. Monty had asked one of his bright, up-and-coming financial analysts to prepare a report on those very transgressions. The conclusion was clear. Had Mr. Monty's predecessors just left well enough alone, stuck to the core telephone business and used the excess cash flow to repurchase BCE shares, earnings per share would be almost 50% higher than their level at year-end 1999.

But, in Mr. Monty's opinion, an organization couldn't stand still or it would wither and die. It was harder than it sounded to just mine the cash flow out of a mature business. Top-notch talent might not stick around.

And the World Was Changing

At that time, giant global telecom behemoths were emerging, with names like WorldCom, Level 3 Communications and Global Crossing. They would have a huge scale advantage when they were finally able to get access to Canada's residential customers. Following this reasoning, if Mr. Monty just stood pat, BCE would eventually be marginalized by massive competitors offering one-stop shopping, and doing so with a huge cost advantage. If there was a reasonable chance of this scenario playing out, something would have to be done. And soon.

Opportunity was knocking at Mr. Monty's door. BCE already owned 23% of Teleglobe Inc. (the entity that prior to 1998 held a monopoly position on transferring international telephone traffic in and out of Canada) and was in a position to purchase the remainder. While this formerly good business was barely breaking even now that it was competing in a deregulated marketplace, it had something that BCE did not – an international network. At the end of 1999, Teleglobe had telecommunications licences or operating authorities in 27 nations, offices in 43 countries and connections with 450 carriers and 60,000 business customers. Buying Teleglobe would give BCE the platform upon which to build a global business that could compete with the big boys.

So, what was the downside? Yes, Teleglobe was burning through cash as it spent heavily to upgrade its global network so it could get in the game. And yes, the roaring bull market in technology and telecommunications stocks meant that Teleglobe's global competitors had access to almost limitless supplies of equity capital that was almost free. Predictably, that was driving a massive gold rush to build out global high-speed telecom networks.

While fundamental economics would argue that too much supply of anything – even bandwidth – will eventually erode prices, bull market participants would hear none of it. Salomon Smith Barney analyst Jack Grubman once called a leading communications stock a buy "at any price" because, given the explosion in new applications that the Internet was driving, demand for bandwidth was infinite.

Mr. Monty made his decision. BCE's purchase of Teleglobe for $10 billion was announced on February 16, 2000, just one month before the peak of the biggest stock market bubble in history. Timing is everything, as Teleglobe's happy shareholders learned that spring. BCE shareholders would see the other side of the coin.

In his presentation to the investment community justifying the Teleglobe purchase, Mr. Monty made much of the boost in BCE's revenue growth rate to 10% that buying Teleglobe would bring. Of course, that was looking out a couple of years. The day before the deal, Teleglobe released results for 1999 that included a 15% drop in sales.

And the World Did Change

Just two years later, a huge $7.5 billion write-down of Teleglobe led to Mr. Monty's departure. What happened? Yes, demand for bandwidth and connectivity services kept growing, but far too many companies had chased the same market. And the free equity capital that was available to Teleglobe's competitors added nuclear fuel to the competitive fire.

The ensuing massive build-out of global telecom network capacity knocked bandwidth prices through the floor. Fundamental economics had stood the test of time: too much supply of anything will drive prices down. How bad did it get? Teleglobe's core voice and data business was sold to a vulture buyout fund for a mere US$125 million in May 2003. This equates to less than 2% of its "worth" just three years earlier.

What characteristics does the Teleglobe blunder share with BCE's historical transgressions? Bell Canada has a long-term competitive advantage in its core local telephone business, but all of the strategic errors were to invest in businesses outside of this area, like real estate and financial services. Investing outside of one's circle of competence, as Warren Buffett calls it, almost always ends badly.

Why do people insist on repeating the same mistake over and over? Part of the answer has everything to do with human nature. People are overconfident as a rule. Surveys suggest that 80% of us think that we are better than average drivers. To some extent this is necessary to deal with life, as studies have shown that the only people who assess themselves accurately in such areas as driving ability, appearance and sense of humour are the clinically depressed.

So-called "experts" are even more infected with overconfidence. Studies have shown that physicians ascribe a 90% confidence level to their initial diagnoses, but achieve only 50% accuracy. And trial lawyers at the outset of a case greatly overestimate their chances of winning in court.

Business chief executive officers (CEOs) are no different. Despite reams of historical evidence that suggest that some 70% of mergers fail to create shareholder value, every executive who attempts one is confident that he or she will buck the odds.

The growth fixation of most public company managements is another reason they do deals. Instead of understanding the company's true competitive strengths and then capitalizing on these strengths, countless CEOs pursue growth merely for growth's sake. Making the company bigger tops the personal agendas of many CEOs. Refusing to acknowledge the economic limits imposed by the competitive capitalist system on the companies they run, many CEOs indulge their obsession with growth by trying to force it through acquisitions. Impatient executives become willing to assume the risk of severe capital loss in order to get to the finish line sooner. But long-term investors don't have finish lines.

Consider this quote from the 1988 BCE annual report: "We are aiming for a steady annual improvement in earnings of five percent or more." [71] This sounded good to us, until we went on to read: "To attain this, it is not sufficient to sit back and watch the various BCE companies go about their business. At the holding company level, we must manage aggressively the assets at our disposal in order to bring about earnings growth and an increase in share value." [72] Of course, the aggressive actions taken the following year included the purchase of Montreal Trustco Inc. at the top of the cycle.

It is dysfunctional for shareholders to have a great business pass through all of its massive cash flow to a holding company run by "aggressive" executives. It is the rare manager at a parent company who is content to sit idly by and "watch the various BCE companies go about their business." It is far more exciting to unleash the animal spirits within by doing deals. Of course, by pursuing sub-optimal investments, especially those outside of the core business, in the end the shareholders lose.

An Investor's Aim is to Compound Capital

Compounding capital steadily and regularly, even at a low rate, is ideal. Management action that impedes the compounding from a reliable business, whether by buying bad assets outside their circle of competence or by selling good assets within it, is the bane of a good investor's existence. Unfortunately for its shareholders, BCE has done both.

What would have happened had BCE just stuck to its knitting since 1987 [73] and concentrated on delivering the targeted 5% growth rate to shareholders? (Earnings from their Canadian telephone businesses actually grew at a compound annual rate closer to 6% over that time period.) We calculate that if management had used BCE's free cash flow to repurchase shares, earnings per share would be more than double today's level. The intrinsic value of BCE's common shares would have gone along for the ride. Instead, management chose to subject shareholders to the risk of interrupting the compounding equation, or worse, suffering a significant capital loss by pursuing investments outside of BCE's circle of competence.

The achievement of even a modest 5% earnings growth rate over many years will drive substantial shareholder value. For example, $1,000 compounded at 5% over 10 years will grow to almost $1,630. Not bad! Of course, add dividends (BCE's current yield is over 4%) and the total return can approach double digits. Pretty darn good when buying 10-year bonds will get you less than 5%.

In addition, we think that there is a good reason why Warren Buffett's number one investing rule is to never lose money (and why rule number two is: don't forget rule number one!). Losses greatly inhibit the compounding of capital.

Consider our 5% compound interest example in the table below. If we were able to juice up the compound growth rate to 10%, the value of $1,000 after 10 years would obviously be far greater – almost 60% higher in fact. But, including only one year with a 30% negative hit would knock the compound result back to exactly the 5% level. And subtracting two 30% haircuts from an otherwise 10% positive annual rate virtually eliminates any growth over the entire decade.

Initial Value	Growth Rate	Value after 10 Years
$1,000	5% per year	$1,630
$1,000	10% per year	$2,594
$1,000	10% per year with one 30% haircut	$1,650
$1,000	10% per year with two 30% haircuts	$1,050

Source: Burgundy Investment Team Research

Negative Numbers Wreak Havoc on Compounding Equations

The best investors understand this sombre fact and look for management teams who will not expose them to negative shocks. But the massive capital misallocation mistakes we too frequently observe suggest that many executives just don't get it.

Outstanding managers know where to draw the line. Much like integrity, which author Flannery O'Connor defined in her 1952 classic novel, *Wise Blood,* to mean "what you won't do," excellent executives simply won't risk shareholders' capital on inappropriate adventures that could upset the compounding equation.

This is not to say that risk-taking has no place in our economy. Far from it. Risk-taking is the essence of wealth creation in our capitalist system. But executives at mature, cash-generating companies are not running venture capital funds where large numbers of investments are made in the hopes that a few huge paydays will occur and make up for the majority that turn out to be losers.

When dealing from the position of strength that an established competitive advantage brings about, the appropriate risk-taking actions are those of a "blocking and tackling" nature. Relentless focus on the core business and on executing a business plan that exploits strong positioning will yield good returns to shareholders. Slow and steady wins, especially when running a mature, well-positioned firm.

Executives should pursue strategies that maximize the long-term profitability of businesses with sustainable competitive advantages. Furthermore, companies should only invest in these businesses if the expected return surpasses a reasonable estimate of the company's cost of capital. This is effective capital allocation.

Ineffective Capital Allocation Will Disturb the Compounding Miracle

Any BCE executive could have saved shareholders a bundle by asking himself one simple question: "Did BCE have a sustainable competitive advantage in offering global telecommunications services (Teleglobe), real estate (Brookfield) or financial services (Montreal Trustco)?" The answer was no. It brings to mind the world champion chess player's advice when asked how to avoid making a bad move. His answer: "Sit on your hands!"

We have a sneaking suspicion that, much like the avoidance of disastrous acquisitions that sticking to one's knitting entails, success from insisting on earning a decent return on allocated capital will come largely from those ill-advised moves that don't get done. We call it maintaining strategic integrity.

So when new CEO Michael Sabia publicly stated that BCE's new strategy was one of simplification where the only focus would be the core telephone business, we applauded. Maintaining strategic integrity is always step one. We have confidence that Mr. Sabia and new board Chairman Richard Currie embrace this. Indeed, having these two superior executives in charge was a key reason we purchased BCE shares for the first time in 2002. We still own them.

However, the new BCE executive team did make another profound mistake. They sold one of BCE's crown jewels – a business with terrific compounding qualities that was well within their circle of competence. Perhaps they felt backed into a financial corner at an inopportune time. They were forced to unwind another past mistake by repurchasing 20% of operating company Bell Canada from SBC Corporation. SBC had bought its Bell stake in 1999, and with it came an option to sell it back to BCE in 2002 at a 20%-plus premium. With global telecom valuations at bear market lows, SBC decided to exercise their option. This forced BCE to come up with $6.3 billion fast.

The fall of 2002 was a tough time to arrange financing given the liquidity crisis that had taken over global financial markets, but BCE did an admirable job. Large bond and equity issues were completed and asset sales were studied. Unfortunately for long-term shareholders, the long line-up of buyers for their Yellow Pages directories business compelled BCE to offload it.

The Bell Yellow Pages is one of the best businesses in Canada. As the fifth-largest Canadian public media company, it has a 93% market share with a renewal rate over 90%, as well as 58% cash flow margins. While growth is slow (sales growth has compounded at 2.6% over the past decade – profit growth has been faster because of operating leverage), it requires almost no capital. For example, at other good free cash flow businesses such as radio and TV broadcasters, capital expenditures consume about 15% of operating cash flow. Directories consume less than 3%. As a result, over one-half of every revenue dollar is available for distribution to shareholders. Having a so-called free cash flow margin north of 50% ranks up there with the best assets in the world.

One way to value a stable and increasing cash flow stream is to treat it like a growing perpetual annuity.[74] Yellow Pages generated about $355 million in pre-tax free cash flow in 2003. If one uses an 8.5% discount rate along with only a 2% growth rate, the pre-tax value of the annuity comes to almost $5.5 billion. BCE sold Yellow Pages for $3 billion to a financial consortium that subsequently flipped it out to the public as an income trust. While taxes complicate the matter somewhat, note that Yellow Pages Income Fund today sports a $5 billion enterprise value. Keeping this asset in-house should have been the only option. Dominant franchises with growing free cash flow streams are scarce, and BCE could easily have handled more debt. Selling it for $3 billion was a major misallocation of capital that hurt shareholders' compounding aims.

An investor's goal is to compound capital. Management action that impedes the compounding from a reliable business, whether by buying bad assets outside their circle of competence or by selling good assets within it, is bad for shareholders. CEOs who instead embrace strategic integrity can generate substantial wealth. Even a small positive number compounded for many years turns into a very large number. That is why in the investment business the magic of compound interest is known as the eighth wonder of the world.

Author: **David Vanderwood, Senior Vice President and Portfolio Manager for Canadian equities**

December 2004

Requiem for a Brewer

Later in 2004, Molson Breweries, a grand old Canadian company, proposed to merge with Coors. There were a lot of things wrong with the plan, especially the price. And the timing was very suspect – Molson had just made an atrociously bad acquisition in Brazil that had cost it 20% of the whole corporation's value. Again, David Vanderwood, assisted by Michael Hatcher, analyzed the capital allocation follies of one of Canada's oldest companies and found them badly wanting. And we showed convincingly why the price Molson was receiving was inadequate. The terms of the deal were somewhat improved for Molson shareholders, after a large number of large shareholders (including Burgundy) demanded it. Today, Molson's, which merged on roughly an equal basis with Coors, contributes over 70% of the combined company's cash flow. But in a company controlled by a dual class share structure, as Molson was, a foolish controlling shareholder cannot be gainsaid.

Appended to The View from Burgundy *was a discussion of our February 2004 issue entitled "The Eighth Wonder" that resulted from conversations with Dick Currie, the Chairman of BCE. Dick, of course, had one of Canada's most distinguished careers as President and CEO of Loblaw for 25 years. Dick took issue with one of our points in our analysis of BCE – the Yellow Pages spinout. He felt that there were good and compelling reasons that it had not been such a bad deal for shareholders as we had indicated. While we did not necessarily agree with Dick's points all down the line, we offered him a chance to have his say, based on his distinguished record of service to Canadian shareholders. We had never offered this courtesy before and may never again, unless it is to someone of Mr. Currie's stature.*

Richard Rooney, 2007

In early 2002, Molson Inc., one of Canada's grand old companies, appeared to have shaken off a history of poor decisions and positioned itself for a bright future.

Under the leadership of Dan O'Neill, a tough former executive of Heinz Foods, Molson had pulled off a classic turnaround, cutting costs and focusing on both its core brewing business and its core brands in the brewery. The share price had performed very well over the previous three years, after more than a decade in the doldrums. Pleased with the market's response to their company's rising earnings in recent years, Molson management began to cast about for a way to continue to grow earnings at a rapid rate.

So there was much anticipation when Molson announced a bold new initiative in Brazil. The company paid $1 billion for Kaiser, that country's second largest brewer. Mr. O'Neill had some background in Brazil, and many analysts expected that Molson might be on the verge of finding a reasonable adjunct to its phenomenally profitable Canadian brewing operations.

Two years later, Kaiser was bleeding cash and losing $100 million per year. Its market share had fallen from 18% at the time of the acquisition to only 10%. The controlling shareholders, their confidence shaken by yet another in a long series of disastrous diversification initiatives, were attempting to merge their company with a U.S. regional beer business, Adolph Coors Company (Coors).

In this issue of *The View*, we will examine the latest pratfall in Molson's history. While it is modestly instructive on a stand-alone basis, we would also like to draw some broader conclusions about diversification from this sad tale. We will conclude by giving a shareholder's view of how management should invest the cash flow from a superior business.

Brazil – What Went Wrong?

The Brazilian beer market is dominated by InBev with a remarkable 68% market share. InBev distributes its product through the Pepsi bottlers in Brazil, who run one of the two distribution systems capable of reaching one million points of sale in that huge country. The only other such system is run by the Coca-Cola bottlers, and the beer they have always distributed is Kaiser. They distributed it because they owned the brewery.

At the time of Molson's Kaiser purchase, the Coke bottlers were having a tough time, squeezing marginal profits out of their system, with incentives mainly centred around increasing volumes. Beer was a bit of an afterthought for these distributors, but as long as it was a profitable afterthought, Kaiser looked like it had a secure place on the distributors' trucks, even though it accounted for less than 5% of the Coke bottlers' revenues. Kaiser also appeared to have a regional stronghold in the Sao Paulo market, Brazil's largest, where market share was apparently over 30%. In a product where loyalties are usually deep and long lasting, that could be a big advantage.

Finally, to secure the continued support of the bottlers, they received part of their selling price for the Kaiser business in Molson stock, which they were not allowed to sell for at least two years.

The wheels began to come off the new Molson subsidiary when a new Coke executive took over in Brazil and revolutionized bottler economics overnight. He replaced the old, volume-driven incentive system with a new profit-driven one that offered much better payouts to the distributors. All of a sudden, it made a lot more sense to stock the truck entirely with Coke products than to throw on a few cases of Kaiser beer. Even worse, it developed that the putative 30% market share in Sao Paulo was illusory and represented simply a lot of transhipment from that city to other regions in Brazil. Finally, to complete a very ugly picture, the third-place brewery in Brazil introduced an aggressive and highly successful marketing campaign that led to big increases in market share for its products.

Unloved by its distributors and consumers, Kaiser fell to the back of the pack in the Brazilian beer market. Perhaps the most painful aspect of its dilemma was the lack of any alternatives – remember, only two distribution systems are set up to reach all of Brazil, and building a separate system for Kaiser would be uneconomic. And the collapse in profits precluded an aggressive marketing spend to fight off the competition.

What is the moral of this nasty story? Well, clearly Molson did not do an adequate job of assessing the risks of this acquisition. Strong and committed distribution is essential to the success of any business, and the structure of the deal obviously did not secure this for Kaiser. The extreme power of the distributors does not appear to have been given enough weight. Mr. O'Neill, who had done a good job of focusing and trimming fat at Molson, was clearly outside his circle of competence in emerging market acquisitions.

The Bigger Issue

But to us, Molson's Brazilian misadventure is a symptom of a larger problem at that organization. As owners since 1786 of a brewery with huge market share in the world's most profitable beer market, normal compounding would indicate that the Molson family should own the entire planet Earth. Instead, through repeated failed diversification initiatives, the company has interrupted the compounding equation over and over again.

How should Molson think about diversification? Well, to us, diversification is desirable in the presence of a significant probability of permanent capital loss. A smart business manager or portfolio manager will always seek to own a number of risky businesses rather than just one. By the same token, owning a highly reliable business with well-protected cash flows reduces the necessity to diversify and in fact gives a strong incentive to concentrate and focus on that business. Corporate America has been reading from this playbook since the early 1980s, especially in areas like consumer branded products, food and beverages. Warren Buffett is the exemplar of someone using the same strategy in the portfolio investment world.

With a great business like Molson's Canadian beer business, time is on your side. You can wait for fat pitches and you never have to swing. The money generated from your business doesn't have to burn a hole in your pocket; you can simply distribute it to shareholders. But let's say you decide that the opportunities for profitable growth are too limited in your small national market. Stella Artois (InBev), SAB and Heineken are examples of companies that came to that conclusion. These companies have shown that breaking into mature beer markets is extremely expensive, though given patience and willingness to absorb either a hefty local acquisition premium or ongoing losses for long periods, it can be done. A riskier strategy is to buy brewers in emerging markets. But with that strategy comes the possibility of permanent capital loss.

Role Playing

Let's look at Molson's position in 2002. We assume they have three alternatives for a $1 billion investment: first, a share buyback; second, purchase of a single emerging market brewery business; and third, purchase of three emerging market breweries with similar risk profiles. We include a fourth column showing purchase of 10 emerging market businesses, not because we feel that is an option with $1 billion, but because it illustrates the risk profile of the strategies pursued by InBev and Heineken. The example is illustrative only and is somewhat simplified.

RISK PROFILE FOR MOLSON'S ALTERNATIVES					
		A	B	C	D
Outcome	Probability	Share Buyback	One Emerging Market	Three Emerging Markets	Ten Emerging Markets
Downside	20%	(5%)	(50%)	(17%)	(2%)
Most Likely	60%	10%	15%	19%	19%
Upside	20%	25%	100%	57%	41%
Expected Return		**10%**	**19%**	**19%**	**19%**

Examining the share repurchase option in Column A leads to a couple of key observations. First, the expected return from the share repurchase is significantly lower than the emerging market strategies. Second, the risk of absolute capital loss is also much smaller (we suspect that over any reasonable time frame it approximates zero, but we're a conservative bunch).

Moving on to the single emerging market acquisition strategy, we see a much higher expected return, offset by a very much higher risk of a 50% absolute permanent capital loss. This is by far the highest risk investment strategy of the four shown here.

Finally, we show the risk profile of buying three emerging market businesses with risk profiles similar to the individual business in Column B. Due to the multiplicative nature of probabilities, you can see that the risk of absolute permanent capital loss is significantly reduced. With 10 such markets, this probability becomes small indeed while the expected return remains the same. This is the whole point of diversification.

This simple example shows why InBev and Heineken have been able to execute their growth strategies successfully and become large multinational beer businesses. By owning large diversified buckets of emerging market brewers, the risk posed by serious problems in any one market is substantially reduced. It also shows that Molson management quite deliberately risked severe capital loss with one, large emerging market speculation. In the case of the Kaiser acquisition, the permanent capital loss appears to be more like 90%. That would mean that fully 20% of Molson's value was wasted in Brazil.

Déjà Vu

If the Molson saga seems vaguely and uncomfortably familiar, it may be because its duopoly partner, Labatt, acted amazingly similar in the early 1990s. In their case, the misadventure occurred in Mexico, and the amount risked was also 20% of Labatt's value. Within months of purchasing 22% of Femsa, a severe monetary crisis caused the investment to fall in value by almost 50%. A shaken Board and management sold out to InBev a few months later. In retrospect, Labatt was sold at far too low a price, and the strong, reliable cash flows from their Canadian asset have allowed InBev to finance many more acquisitions. Clearly, a very high market share position in a phenomenally profitable beer market like Canada's should not be given up lightly or cheaply.

This brings us to the Molson proposal to merge with Coors. We believe that the price being discussed is far too low. If it proceeds under the last terms discussed, shareholders will have received another value-subtracting blow at least rivalling the one they suffered in Brazil. Having purchased Molson shares in the aftermath of the Brazilian debacle, when we felt that the Canadian assets were no longer being appropriately valued by the market, we now find that they are not appropriately valued by management and the controlling shareholders either.

The basic problem is that the price being discussed does not reflect the superior profitability of Molson's Canadian operations. The mysterious decision to focus on EBITDA (earnings before interest, taxes, depreciation and amortization) is the culprit.

EBITDA is supposed to be a measure of cash flow generation capacity, and on that basis Coors makes the point that its stock trades at 6.6 times EBITDA and Molson will be merging at 9.6 times EBITDA. Sounds like a fat premium, doesn't it?

Alas, this number is never very meaningful (Charlie Munger referred to it as "bull---- earnings" at last year's Berkshire Hathaway annual meeting) and in the current context it is horribly misleading. Molson's beer business is vastly more profitable than Coors' beer business. The differentiating factor is the depreciation expense. If this (very real and burdensome) charge is treated appropriately as an expense, you can see that measured by EBIT (earnings before interest and taxes), a much more stringent and meaningful measure of free cash flow, Molson is merging at a discount to Coors. A company with profits per hectolitre almost four times those of its merger partner, merging at a discount! This makes no sense at all. Coors paid a 30% higher EBIT multiple to acquire Carling's U.K. business, a far less valuable property.

TRANSACTION DETAILS

	Molson [75]	Coors [76]	Carling U.K. Acquisition [77]
EBITDA Multiple [78]	9.6 x	6.6 x	8.0 x
EBIT Multiple [79]	10.3 x	11.7 x	13.5 x
Depreciation/ EBITDA	8%	43%	43%
Core Market Share	43%	11%	21%

So on its merits, we believe that Coors and Molson should go back to the drawing board to come up with a new formula, one that reflects Molson's superior economics. Molson should be valued at least in line with Carling, one would think. If the deal goes through at current prices, it will be largely because of the unbridled and undeserved power wielded through the egregious dual class voting structure. But don't get us started on that again.

Conclusion

The Molson saga shows the ongoing effects that misunderstanding diversification can have on a business. Molson really did not need to diversify at all – it was driven to do so by arbitrary earnings growth targets developed by management (and cheered on by shortsighted, short-term oriented shareholders). The growth targets were inappropriate for a slow-growing, but very profitable business. Now Molson proposes to double down its Brazilian error by making a fundamental valuation mistake in its merger negotiations. A brief reality check is revealing – if Molson had used the $1 billion to buy back stock in 2002, and then merged at 13.5 times EBIT, the share price would be $61 by our estimation – a far cry from current levels.

Since 1980, Molson has been grappling with a thorny problem: If you own a powerful, cash-generating, low-growth business, what should your strategy be? How can you open up new growth avenues while intelligently diversifying risk? We would suggest the following checklist:

1. If you own a great business and you can profitably invest in it, then that is the best use of the cash it generates. Such investment can take the form either of spending on marketing, production efficiencies, new facilities or buying back the company's stock. Investing in operations you know best, and in a stock whose intrinsic value you understand, should be the first priority of any management of a great business. It may appear to be lower return, but it is almost invariably lower risk as well.
2. If there are almost identical businesses that can be tucked under existing operations and skill sets, then acquiring these businesses is the next best use of cash, assuming those businesses are available at a sensible price.
3. If the company has advanced skills in managing acquisitions or organic growth in the same industry in foreign countries, then that is a perfectly viable use for the shareholders' money.
4. If the company wishes to build these acquisition or operations skills, then management should start slow and perhaps in minority positions, never risking very large amounts of shareholder capital.
5. Investing in unrelated businesses is almost invariably an error.

The history of the Molson companies is a long list of violations of all these common sense precepts. Too bad – with a heavyweight business in a great industry, and intelligent capital allocation, Molson could have been a contender.

Reasonable People Can Disagree

In the aftermath of our *The View* entitled "The Eighth Wonder," we received a visit from Dick Currie, the chairman of BCE and former president of Loblaw. Dick had some concerns that our recounting of the events surrounding the divestiture of BCE's Yellow Pages business left out certain information that he considered critical to the final decision. While it is not uncommon for us to be contacted in the aftermath of an issue of *The View*, we have hitherto not allowed anyone to respond to our remarks in this forum. But in view of the long and inordinately distinguished career he put together as president of Loblaw, we decided to make an exception for Dick Currie. We are willing to extend a similar platform to anyone who puts together a 20-year record of shareholder value creation like he had at Loblaw. Those with lesser track records need not apply.

So, what were Dick's concerns with our analysis? They chiefly revolved around three issues. One was lack of credit given for the very sophisticated tax planning that resulted in BCE not having to write a huge cheque on the disposition. Another issue was the forecast growth rate for the Yellow Pages business. As our readers will recall, we had forecast a modest rate of growth going forward. Mr. Currie takes issue with this estimate, and feels that looking to the U.S., where trends are more advanced, would give rise to a much more conservative forecast that would essentially call for a modest annual decline in the business going forward. Factoring such a decline into our methodology would reduce our estimate of the value of the business substantially.

Finally, Mr. Currie pointed out that the divestiture was made under substantial time pressure since BCE was buying back the 20% of Bell Canada's operations that were sold to SBC by another management team some years before. Management feared a ratings downgrade for its debt if cash came from a debt issuance rather than a sale of assets.

We note Dick's arguments while not necessarily agreeing with all of them. Certainly the performance of the Yellow Pages units would indicate that BCE shareholders left a large sum of money on the table. But we understand that an executive as dedicated to shareholders' interests as Mr. Currie would feel that he needed to tell his side of the story, so we have offered him this courtesy. As shareholders of BCE, in part because of our confidence in him and CEO Michael Sabia, we wish him well.

Author: **David Vanderwood, Senior Vice President and Portfolio Manager for Canadian equities**

2005 – 2009

2005

Series of co-ordinated suicide bombings target London's public transit system

2006

Warren Buffett donates 85% of his fortune

2007

C$1 equal to US$1 for the first time in 31 years

2008

Global financial crisis takes hold:

- JPMorgan Chase acquires Bear Stearns
- Fannie Mae and Freddie Mac bailout
- Lehman Brothers files for Chapter 11

2009

Fitch downgrades Greece's credit rating

September 2005

No Good Deed Goes Unpunished

This issue of The View from Burgundy *represented a chance to look beyond the horizons of North America to a disturbing and shadowy struggle for control of one of our favourite companies, Deutsche Börse. Behind-the-scenes manoeuvring had led to the ouster of the CEO of Deutsche Börse (DB), Dr. Werner Seifert. The immediate cause of controversy was a bid by DB for the London Stock Exchange (LSE), which at 530 pence was considered too rich by a hedge fund manager in London. Since three years later the current price of LSE stock is 1296 pence, we think that he was demonstrably wrong. Anyway, the themes of skullduggery and conflict of interest, and above all, short-termism, resonated with our audience, who are concerned about these issues as well. Stephen Mitchell and Ken Broekaert did most of the work on this well-received issue.*

Richard Rooney, 2007

On May 9, 2005, Dr. Werner Seifert, the CEO of Deutsche Börse AG, Europe's most important securities exchange, was forced to resign by dissident shareholders of his company. Over Dr. Seifert's 12-year tenure at the helm, Deutsche Börse emerged as an important innovator of new financial products and an unrivalled platform for securities transactions. The company had earned outstanding long-term returns for its shareholders. So why was its CEO forced to resign?

In this issue of *The View*, we go afield from our usual North American haunts to examine the shareholder revolt at Deutsche Börse. First, we will recount the story, then examine some of the underlying trends and, lastly, try to draw some lessons for long-term investors and corporate managers from this very instructive tale.

Deutsche Börse AG (DB)

Germany contains several stock exchanges, mirroring the country's fragmented past. In the post-World War II period, the exchange in Frankfurt am Main became predominant and today boasts a market share of about 86% of Germany's listings and trading. The Frankfurt Exchange (known as Xetra) became the core of a new public entity called Deutsche Börse AG in the early 1990s. (We briefly outline the various businesses of Deutsche Börse in the profile below.)

PROFILE OF DEUTSCHE BÖRSE (DB)

DB is among the most successful financial exchanges in the world. It has five closely related and highly profitable businesses that conduct pre-trading, trading and post-trading activities in stocks, bonds and derivatives:

- **Xetra** is built around the ancient Frankfurt Stock Exchange, one of Europe's oldest, founded in 1585. It accounts for 15% of the DB's operating profit, with 40% operating margins. This is what Dr. Seifert had as his original growth platform.
- **Eurex** is among the highest volume derivatives exchanges in the world with almost 100% share of the European derivative contracts that it trades. Eurex generates over 30% of DB's operating profits and earns over 43% operating margins. This business was virtually started from scratch and has grown organically to its current dominant position in head-to-head competition with Euronext.Liffe.
- **Clearstream** is one of two Pan-European securities settlement and custody businesses. It represents 31% of DB's operating profits and earns 30% operating margins. It was created from a combination of DB's domestic post-trade business and Cedel International's Pan-European and international business.
- **Information Technology** is the external sales arm of DB's large internal IT consulting department. It provides trading platforms for smaller exchanges such as Shanghai and Dublin. It represents 16% of DB's operating profit and earns 72% operating margins.
- **Market Data and Analytics** sells the pricing data from Xetra and Eurex to investors. It currently generates 8% of DB's operating profits at 37% margins.

With its rather closed financial system and lack of an equity culture, Germany's exchanges seemed ill-placed to compete in the deregulating late 20th-century environment against long-established international markets like the London Stock Exchange or new supra-national exchanges like Euronext (the merger of the Paris, Amsterdam and Brussels exchanges) for the burgeoning volumes of internationally traded securities and derivatives.

But DB surprised everyone. Under the leadership of Dr. Werner Seifert from 1993, Deutsche Börse consistently won market share against all European exchanges. It launched products that met new investor needs and built systems capabilities that gave DB perhaps the most efficient, reliable and transparent trading platforms in the world. Financially, it was a home run with compound 11-year growth in earnings per share of 22% on compound revenue growth of 18%. The returns to shareholders were outstanding at 24% compound with dividends reinvested.

Dr. Seifert had a most distinguished record as chief executive of DB. He had the huge advantage of being in charge of a very good business with very high returns on capital and exceptional cash flow characteristics, during a very strong capital markets cycle. Though his capital allocation record was not perfect, in almost all cases, Dr. Seifert took strategic directions that allowed non-dilutive growth for shareholders. In our experience, that is a rarity – managers of really good businesses usually cannot stop themselves from "watering the weeds" by making dilutive acquisitions. There are thousands of CEOs more deserving of censure than this gentleman, in every market we can think of, and few more deserving of gratitude from shareholders.

Yet, despite this stellar record, Dr. Seifert was forced to resign by insurgent shareholders because he proposed an acquisition that made great strategic sense, but went against the wishes (and probably the short-term oriented trading strategies) of those shareholders. The whole issue centred on a proposed takeover of the London Stock Exchange (LSE) by Deutsche Börse.

Strategic Crossroads

In the late 1980s, the London Stock Exchange was considered perhaps the major market best positioned to benefit from the new trend to deregulation and European integration. Yet, it consistently finished behind DB and Euronext in returns and strategic aggressiveness. The LSE was managed unimaginatively and repeatedly missed opportunities, including losing to Euronext in a bid for the London International Financial Futures Exchange (LIFFE) despite offering a higher value bid. The result of these missed opportunities is that the LSE's market capitalization and operating profits are only 23% of Deutsche Börse's and 50% of Euronext's, making the LSE a logical acquisition target. Ever logical, DB management proposed, in late 2004, to acquire the LSE for 530 pence per share, a premium of 52.3% over its pre-bid price of 348 pence.

The proposal drew an immediate negative reaction from certain large shareholders, particularly and most prominently a London-based hedge fund called The Children's Investment Fund (TCI), led by the dynamic Mr. Christopher Hohn. Taking the majority of his position after the bid was proposed, Mr. Hohn pointed out in letters to the Supervisory Board of Deutsche Börse that, in his opinion, the proposed price was too high, and that a major share buyback would be a preferable use of DB's cash hoard and great financial strength. As a holder of perhaps 8% of Deutsche Börse's stock, TCI's opinions counted.

Although Burgundy owns somewhat less of DB, it is our largest European position, and we had a different assessment of the proposal. In our opinion, the proposal price of 530 pence was likely to provide an attractive return to Deutsche Börse shareholders over the medium and long term, given the attractiveness of the LSE's business and the high level of achievable cost savings.

We felt that the acquisition was more desirable than a stock buyback. Merger opportunities like the London Stock Exchange are scarce and unrepeatable, unlike a stock buyback, which is a permanent capital allocation option for any company with the financial wherewithal to undertake it. Presumably, a merger with the LSE would give DB management opportunities for innovation and growth, for expense reductions at the acquired company and for economies of scale for the merged entity. In turn, this increased scale, profitability and scope would give Deutsche Börse a competitive advantage, which, in the last analysis, is the source of superior returns for shareholders.

The Dissidents' Campaign

Of course, reasonable people can disagree on these matters, as Mr. Hohn and his allies clearly did. But, the debate on the merits of the London Stock Exchange proposal soon shifted to a very different type of campaign, one that brought into question the track record, corporate governance practices and even personal ethics of DB's managers. The dissident shareholders appealed to various prejudices and constituencies in the London financial establishment and media.

A potpourri of accusations descended on Deutsche Börse's management and Board both from dissident shareholders and from the media. Among them were accusations of insider trading by Board members in LSE shares; conflict of interest by the Chairman of DB (he was also the Chairman of Deutsche Bank, which would have acted as agent for Deutsche Börse's LSE bid); and improper accounting for the 2002 Clearstream acquisition in order to disguise its allegedly value-destroying characteristics.

The German regulators and the Board of DB launched investigations into all these allegations (in the case of the Board, hiring outside auditors and lawyers with no existing connection to Deutsche Börse). The investigations completely exonerated management of any wrongdoing prior to the May 25, 2005 Annual General Meeting. But the smear campaign had changed the whole focus of DB's management from selling the strategic acquisition of the LSE to defending against unfounded, and sometimes anonymous, allegations in the press and from shareholders.

Concurrent with this torrent of accusations, Mr. Hohn of TCI gathered together an alliance of hedge funds and some very large, long-only asset managers (managers who are not allowed to short stocks as part of their mandate, unlike hedge fund managers who are not similarly restricted). Even though they accounted for less than 20% of DB's voting stock, they would be able to oust management due to the very low historical proxy voting by Deutsche Börse shareholders (participation has traditionally been less than 35%). As the date of the annual meeting approached, it became apparent that the dissidents would indeed be able to impose their will.

Most of the dissidents' goals were accomplished before the actual vote, as they forced the resignations of Dr. Seifert and the Chairman, Dr. Breuer; the withdrawal of the London Stock Exchange proposal; and the initiation of the €1.5 billion share buyback program when it became obvious that they had enough votes to win. TCI did not actually have to vote their stock against management, and thus avoided regulatory scrutiny for this coup! They have continued to influence the Board significantly after the AGM by playing a role in selecting a majority of the new Board and will likely be closely involved in appointing a new CEO for Deutsche Börse. In other words, they effectively control the company with only about 8% of the stock – an absolutely remarkable result.

Motivations?

Shareholders often disagree with their managements about strategic matters. Most of the time, they are unwilling to impose their will on management, which is one reason that history is littered with examples of horribly overpriced and misguided acquisitions. Replacing managements expeditiously, even after such disasters, is a comparative rarity, and usually a management team that has performed its duties competently would be given the benefit of the doubt. Given its stellar long-term track record, why was that benefit not forthcoming for DB's management?

We suspect the reason is the financial motivation of the dissidents, especially those who were capable of doing paired (long/short) trades. Just consider the long/short profit opportunity that arises from destroying the DB/LSE proposal. The LSE's price was bid up substantially in the aftermath of the Deutsche Börse proposal to levels that actually exceeded the proposed bid price. DB's share price sagged as acquisitors' share prices usually do. So Deutsche Börse was trading well below its stand-alone intrinsic value and the London Stock Exchange was well above. If you went long DB and short LSE, foiled the bid and put a major stock buyback in place at Deutsche Börse, you could achieve paired trade nirvana – a huge immediate appreciation in your long position, and a major profit on your short position as London Stock Exchange, deprived of the takeover premium in its stock, declined towards pre-bid levels.

The strange twist in the Deutsche Börse story was that the behaviour of the longs and shorts was virtually the mirror image of a normal paired trade. Normally, the short sellers are slagging the company they have sold short, and puffing the company they are long. Normally, the managers of the company sold short are in an inimical position to the short sellers, while the management of the long position company are allied with their shareholders. In this peculiar instance, the managers of the London Stock Exchange were probably cheering for the shorts, since if DB's bid succeeded, their job tenure was very doubtful. And the long shareholders were attempting to discredit and replace the expert management of the company whose shares they owned outright.

For the long-only managers in the dissident group, the prize was the potential for an immediate gain from the Deutsche Börse share price appreciation. But there was another possible wrinkle. Some of the long-only managers involved in the dissident group were also very large shareholders of Euronext, and Euronext is the only other credible bidder for LSE. Since another bid by DB appears extremely unlikely, Euronext may in the future be able to acquire the London Stock Exchange at a very attractive price.

Now, here is an ethical swamp. Most economic theory, corporate governance activism and regulation are based on the assumption that shareholders are interested in the long-term best interests of the company in which they have invested. But what if some shareholders are sabotaging sensible strategic moves because they are seeking short-term profit opportunities while furthering the interests of a competing company? What if the shareholders have a conflict of interest?

Short-termism

Stepping back from this peculiar example, what are the driving forces at work here? We believe that the overriding one is an emphasis on short-term profit at the expense of long-term value creation.

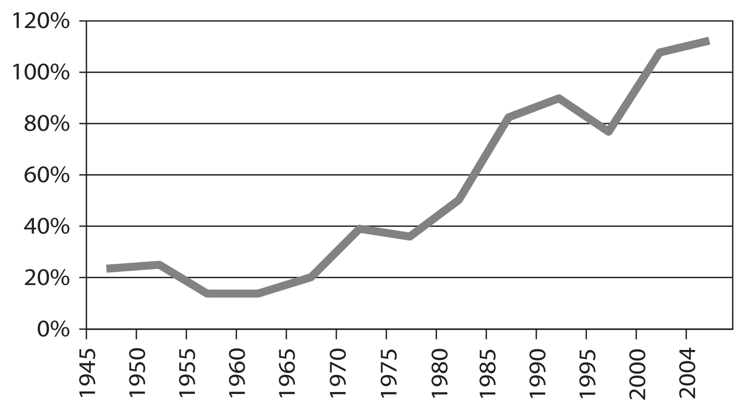
Short-termism in the capital markets can be seen in several guises – for instance, in the steadily rising turnover in mutual fund portfolios (see the following table). Clearly these funds, with an 11-month average holding period for their positions, care only about short-term trading profits. A great many shareholders do not exercise their voting rights, or even acquaint themselves with the managements or fundamentals of the businesses they own in their portfolios. They rush headlong and late into situations like the Deutsche Börse imbroglio that seem to promise short-term profits.

We have always advocated that shareholders behave like owners. They should seek to understand their companies, know their managements and vote their stock. The corollary of this type of stock ownership is that investments should be made only after performing careful research and should be held for the long term. We see no reason to change this position.

Even institutions that hold positions in equities for long periods contribute to the short-term orientation of today's capital markets by lending their securities in order to earn a small incremental return on them. The securities are loaned to people who want to sell them. Increasingly, these short sellers are hedge funds. Short sellers pay a rate of return to the lending institution, and undertake to pay the owner of the stock all dividends that the borrowed stock will pay during the period that the loan remains outstanding. The meter is running on the short sale from the moment it is made, and the sooner the short can "cover" by repurchasing the stock and returning it to the lender, the lower the short seller's costs, and the lower the price of the borrowed stock when the short covers, the higher the profit.

Institutions seem to assume that short selling is a passive activity, when in fact short sellers are always willing, and increasingly able, to negatively influence the fundamentals of companies in pursuit of short-term trading profits. We have heard stories of short sellers calling the auditors of public companies and threatening to sue if they issued a clean opinion; calling suppliers of public companies to tell them their customer was going bankrupt and that they should put them on cash terms; threatening directors with lawsuits to try to force high profile resignations; and making allegations that had to be handled by regulatory investigations. And, of course, the use of the business press by short sellers is now widespread, as reporters get to look like sophisticated and subversive muckrakers while acting as a cat's paw for those who make money from their bearish stories.

U.S. EQUITY FUND PORTFOLIO TURNOVER



Source: "The Mutual Fund Industry 60 Years Later: For Better or Worse?" *Financial Analysts Journal*, 2005, Vol. 61 No. 1

It follows that if short selling is a major source of a short-term orientation in the capital markets that is inimical to long-term value creation, then true investors should seek to make it more difficult and expensive to do. At the very least, such a result would thin the herd of hedge fund managers to those who possess skill, genuine valuation insights and value-added strategies.

The best way to limit the practice of short selling is to restrict the supply of borrowed stock. It is an absurdity that pension and endowment funds that are trying to generate returns based on long-only stock picking would give others the opportunity to speculate against their portfolios through lending securities to short sellers. We strongly recommend that investors discontinue the practice of lending securities.

So shareholders should act in their own best interests by attempting to know and understand the managers and businesses of the companies they own, and discharge their duties by voting on the issues that concern the company. They should refuse to lend their stock, whatever the blandishments and inducements of the trust companies, banks, brokerages and other custodians who make a great deal of money from this practice.

What can corporate managers do? Well, the flip side of shareholders behaving like owners is for managers to treat their shareholders like owners. They should seek out and sustain relationships with them, and refuse to indulge in short-term games like earnings guidance. Real owners don't care what next quarter's or next year's precise earnings will be – they are interested in the long-term strategy, culture, fundamentals and drivers of the business; in other words, in the creation of long-term value.

Educating long-term shareholders on these matters should be part of management's job. When one considers the huge amount of time that Deutsche Börse management spent responding to the demands and accusations of the dissident shareholders, the relatively small investment of time to keep long-term shareholders informed and supportive seems like a worthwhile activity.

Capital allocation can also encourage long-term shareholders. The best mechanism for this activity appears to be the dividend. Because shorts are responsible to pay dividends to the lender for the period of the securities loan, issuing dividends adds dramatically to the cost of short selling and, therefore, can act as an inhibitor. Dividends are also coming back into vogue because they are an indicator of corporate health. Corporate earnings have become too prone to manipulation in recent years. You can't fake a cash distribution, and managers are famously reluctant to cut or pass dividends.

By contrast, share buybacks (the major alternative to dividends as a cash distribution to shareholders) have been tainted by their more or less overt use to prop up stock prices for option-holding managements. Stock buybacks have their place, and should definitely be used aggressively when a company's stock price is depressed and for strategic restructurings of the balance sheet, but for ongoing distributions to shareholders, we have come to prefer dividends. (Intelligent public policy that would reduce taxation of dividends would also be useful.) Managements should always remember that a dividend returns cash to those who wish to own your stock; a stock buyback returns cash only to those who wish to sell it.

Conclusion

The Deutsche Börse story is a strange one in many ways. The reason it fascinates us is that it seems to typify the "what have you done for me lately" attitude of many shareholders in the new century.

Short-termism is not a victimless crime. It has been creeping up on us for years. In its earlier manifestations, it simply demanded earnings increases every quarter, and drove managements to give earnings guidance and sometimes manipulate earnings. Later it made managers embrace compensation schemes like stock options that aligned managers with very short-term oriented shareholders in seeking to pump up stock prices by any available means. And now, it appears that short-termism will increasingly affect the capital structure decisions and growth strategies that managers implement on behalf of their shareholders.

These decisions are the very essence of stewardship and we wonder if shareholders are aware of what they might potentially be losing if companies end up remote-controlled by financial engineers. A company is not just an accumulation of assets and liabilities. It is a living organism with its own culture and rules, and it needs strong and committed leadership in order to thrive.

We have always tried to be realistic about our place in the capitalist firmament – the real stars are the executives who can go out every day, energize their people and implement the strategies that make us wealthier as shareholders and as a society. Dr. Werner Seifert was one of these, and we regret his departure.

Authors: **Richard Rooney, President and Chief Investment Officer**
Ken Broekaert, Senior Investment Analyst

June 2006

Avoid the Coming Oil Slick

David Vanderwood, Senior Vice President and portfolio manager of Canadian Equities and Global Focused Opportunities at Burgundy Asset Management Ltd., delivered the following speech on the occasion of the firm's Client Day, May 4, 2006.

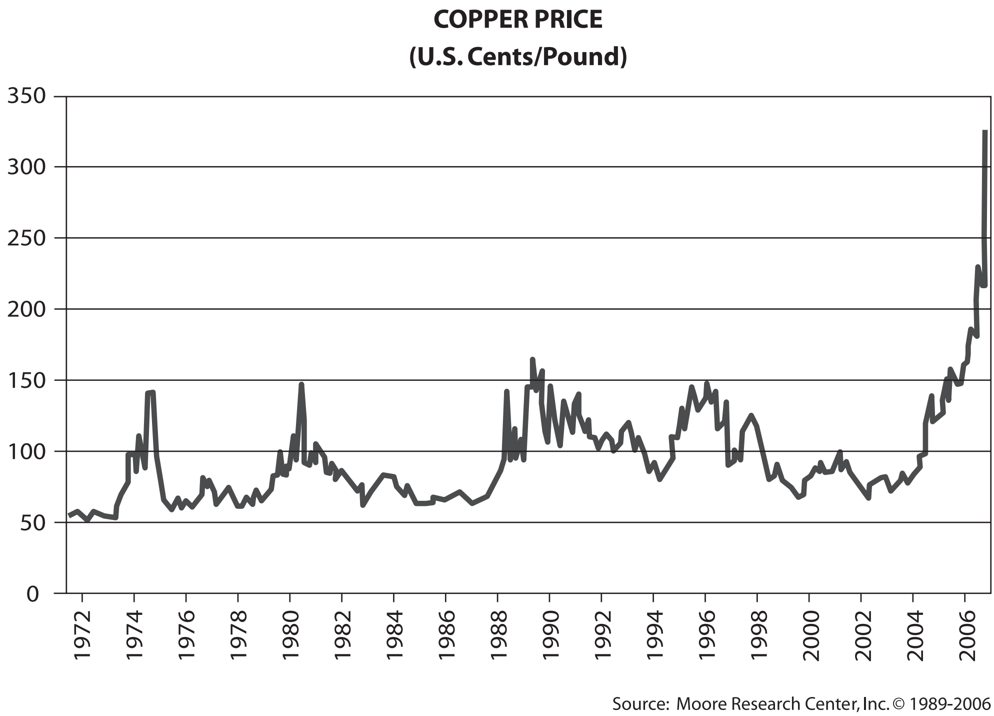
The world is seeing an incredible commodities boom. You might be wondering if Burgundy is missing the gold rush. I am here to tell you that nothing could be further from the truth. We see a big slick coming in oil, and trouble for other commodities, and we have positioned our investments to avoid both.

Before I get into why I see the big slick coming, let us remind ourselves why we are all here. Our goal is to compound your capital. With that as our objective, we look to the Forbes 400 list of the most successful capital compounders for guidance. The vast majority of members owned and ran a good business for a long time. Or, in the case of successful investors on the list, like Warren Buffett, they invested in good businesses and held them for a long time.

What are conspicuous by their absence are speculators in commodities. There is only the occasional guy like Dennis Washington who purchased, in his Chief Financial Officer's words, "on a purely speculative plan," [80] a closed copper mine at a market bottom in 1985. Copper prices spiked shortly thereafter to make his fortune. But even Mr. Washington was wise enough to invest his huge, but temporary, mining profits into some good businesses, which ensured his place on the Forbes 400 through the inevitable cycles.

Marginal Production Cost = Long-term Equilibrium Price

And make no mistake, the cycles are inevitable, and the copper price in the following chart is a great example. Commodity prices cycle around their respective industry's marginal cost of production – or the cost to bring the next so-called "marginal" project on-stream – because both supply and demand respond to price. This is Economics 100 and it works.



When prices are low, high-cost production is closed down. When prices rise, old mines are re-started and new mines are built to cash in. When a commodity is cheap, we use too much of it. But if the price moves up, conservation kicks in and we find alternatives. So the cure for high prices is high prices.

Today, all commodities are trading above their marginal production costs. A marginal copper mine can be brought on with US$1.30 per pound extraction costs. Today's price is $3.25, so many marginal copper projects are in the works. This new supply will eventually surpass demand, so it is not a matter of whether copper and other commodity prices will fall, but when.

Mr. Washington had the good fortune to find a willing seller at the bottom. Atlantic Richfield Company was divesting its mines because it was losing money due to low copper prices. The history of commodity production is one of booms and busts, and it makes it extremely tough to compound capital because the inevitable capital losses during the busts hammer the compounding equation.

Negative Numbers Kill Compounding

This is the profound idea behind the magic of compound interest. Negative numbers wreak havoc on the end result because they shrink the base value from which to begin compounding again once prices recover.

This next example demonstrates this concept. The table shows the annual results from two portfolios, which we have called Volatile and Stable. Volatile generates 30% annual gains followed by 10% losses perpetually, while Stable churns out 20% years followed by break-even results. For both, the result looks the same – the arithmetic average annual return is 10%.

VOLATILE AND STABLE ANNUAL PERCENTAGE RETURNS											
Year	One	Two	Three	Four	Five	Six	Seven	Eight	Nine	Ten	Arithmetic Average Return
Volatile	30	(10)	30	(10)	30	(10)	30	(10)	30	(10)	**10**
Stable	20	0	20	0	20	0	20	0	20	0	**10**

This may cause us to conclude that the return to investors after the passage of time will be the same, but that would be wrong. After a number of years – we picked 10 but the math works for any period – the compound annual return of the Volatile portfolio, which included big gains as well as losses, is a full 1.3% behind that of the Stable portfolio, which reported smaller gains, but no losses. This is highlighted in the next table.

While this 1.3% gap may not sound like much, it's on an annual basis, so it compounds. It also happens to be the difference between reporting an average Canadian equity return over 10 years and one in the top 25%.[81]

COMPOUND AVERAGE ANNUAL RETURNS ARE DIFFERENT		
	Arithmetic	Compound
Volatile	10%	8.2%
Stable	10%	9.5%
Difference		**1.3%**

Compound Returns are the Ones You Keep

The important point is this: Despite both portfolios having an identical arithmetic average annual return, the fact that one includes losses hurts its compound annual return. And the compound return is the one you keep.

This is because of something we call the asymmetry of negative returns. The table on the next page shows how much the subsequent return must be after a given loss, just to break even. Notice how the gap between the two grows as the losses get bigger, a relationship captured by the third column. This is the asymmetry I was talking about.

The more you lose, the worse it gets. And if you ever lose 100%, it's all over. That is why Warren Buffett's number one investing rule is: Don't lose money. And why rule number two is: Don't forget rule number one!

THE ASYMMETRY OF NEGATIVE RETURNS		
Initial Loss of Capital	**Subsequent Gain Needed to Get Back to Starting Point**	**Size of Necessary Gain Compared to Realized Loss**
(%)	(%)	(%)
10	11	111
20	25	125
30	43	143
40	68	168
50	100	200
60	150	250
70	233	333
80	400	500
90	900	1000
100	Impossible	N/A

Could the market, as represented by the S&P/TSX Index, be down 20% or even 30% from today's level in the event of a global recession that hammers commodity prices? Sure. And look at how much ground the Index would have to make up just to get back to square one.

Today's Boom Emerged from the Last Bust

The current commodity bull market is a typical cycle, though a very powerful one. A period of weak prices after the Asian economic crisis of 1997 led to a stretch of underinvestment in productive capacity, so when global demand improved, supply was caught a little short. The world has seen these busts followed by booms countless times. The fact that global growth in 2004 came in at more than 5% – the fastest in 28 years, and 2005 was almost as strong – has thrown fuel on the fire.

With commodity prices now strong, new supply is on the way. For the source, look to the almost-daily expansion of new or existing mines, to the old-mine re-start announcements from major mining companies and to the TSX Venture Exchange. The market value of all the listed companies on this exchange, mostly mining and energy, has grown fivefold over the past five years to $50 billion. On London's similarly speculative AIM market, the value has risen by a remarkable seven times since 2002 to $20 billion for each of the mining and oil and gas sectors. It's a great time to finance a mine.

Seeing that kind of new-found riches in the hands of mining and oil stock promoters reminds me of W.C. Fields's reply when asked what he did after coming into some money. He said, "I spent half on whisky and the rest I wasted."

While a lot of this value on the venture exchanges will be wasted on moose pasture, so too will there emerge a lot of marginal – but also some world-class – metals, minerals and oil projects that will eventually be producing. The irony is that many will be money losers, as the new supply they represent drives prices down.

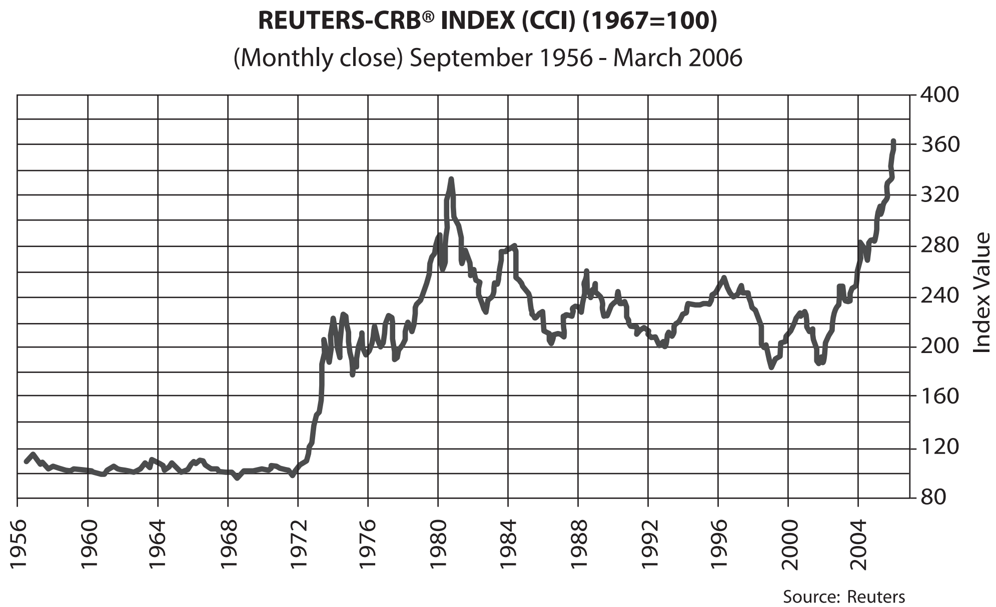
What has this cycle dangerously nearing bubble proportions has little to do with supply and demand. The huge influx of capital into hedge funds has these vehicles searching for speculations, and it seems the flavour-of-the-month is to ride the commodity wave. New capacity does take time to bring on, with environmental permitting getting tougher and labour shortages in places like Alberta's tar sands slowing things down, so a popular trade has been to bet that strong global demand and delays in bringing on new supply will last long enough to make a killing on commodities.

This risky investment thesis has worked. With 2006 expected to be the fourth year in a row that the global economy grows faster than 4%, the hedge funds are upping the ante. The weight of money can be a self-fulfilling prophecy for a while. Remember the billions of dollars thrown at technology and tech-heavy index funds in 1998 and 1999, which drove even more buying of absurdly valued tech stocks at the top. It is happening again today, only commodity markets are far less liquid than stock markets, making the price impact and the eventual comeuppance enormous.

Barclays Capital says that institutional investors are holding over $100 billion in direct commodity investments, double the level of three years ago and up from $6 billion in 1999. And Scotia Capital, in an April 2006 Metals and Minerals report called "A Financially Engineered Supercycle," states that investments in metal index funds alone are $70 billion, up from $15 billion two years ago.

These are huge numbers, given that about $110 billion worth of these metals are consumed each year, using 10-year average prices. And it is clearly impacting commodity and stock prices.

And it's not just the hedge funds anymore, as more and more pension funds and other institutional investors are jumping on the bandwagon. Feeding this frenzy are investment advisors demonstrating that commodities have performed as well as equities over the past 50 years, with very little correlation. The following chart is the CRB Index, a collection of all major commodities.



This shows you how "end-date sensitivity" can influence results. The end date used to generate these impressive commodity returns today comes after the most impressive price spike in history. If you had measured the 50-year returns from 1950 to end in 2000, then you would have come to a very different conclusion, namely 47 years of going nowhere, save for two brief spikes in the 1970s.

Of course, 2000 was the time to buy the stocks of commodity producers, when everybody was convinced that tech and telecom were the only games in town, but only deep-value contrarians were interested because the trailing five-year returns were brutal.

The Five-year Psychological Cycle

Today's commodities hype speaks to what Legg Mason's Bill Miller calls the five-year psychological cycle. People want to buy today what they should have bought five years ago, namely oil and commodity stocks, because of their great five-year trailing returns. Back then, everybody wanted tech stocks, venture capital and U.S. mega caps because they had great five-year trailing returns.

The time to buy them was five years before that, in 1995, when they were cheap. But in the mid-1990s, the herd wanted small and mid-cap stocks and banks, which of course had outperformed during the preceding five years because they were cheap and out of favour in 1990. And so on. Taking advantage of this five-year fallacy is what being a contrarian is all about. It means using a longer-term time horizon than most are comfortable with. And that is why it works.

So it is no surprise that a lot of money is chasing commodity exposure, whether through direct ownership or ownership of resource stocks. Of course, with little or no income from these commodity holdings, and with their history of volatility, they hardly qualify as buy and hold investments. So these new buyers will eventually be sellers. And with risks increasing with rising prices, all we can say is: look out below.

In Canada, investors are not worried, as resource stocks today make up 47% of the S&P/TSX Index.

SECTOR MARKET VALUE AS A PERCENTAGE OF S&P/TSX INDEX		
	Technology	Resources
July 2000	41%	–
May 2006	–	47%

Source: Burgundy Investment Team Research

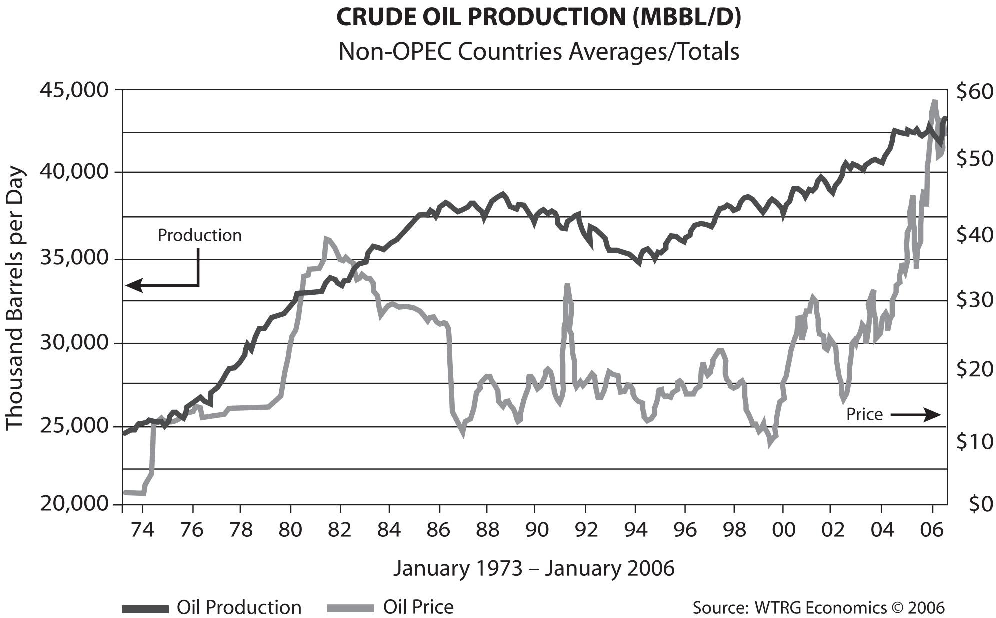
This is a bigger weighting than tech at the top, and we all remember what happened after that. PIMCO's Bill Gross calls it the tyranny of index investing, where owning a so-called "safe" position in an overpriced index turns out to be anything but safe. Investors learned this lesson after 2000 and are poised to learn it again.

Some claim that oil is different, that it is the one commodity that we really could run out of. Proponents of this theory, such as investment banker Matthew Simmons in his recent bestseller, *Twilight in the Desert*, cite a paper published by Shell geologist Dr. King Hubbert in 1956, which correctly predicted the peak and then rapid decline of U.S. lower 48 states oil production. The oil bulls feel that the same thing is happening on a global level.

We don't buy it. And neither does Exxon, the biggest oil company in the world. Exxon's current estimate of world conventional oil resources stands at over 2 trillion barrels, and a similar amount is held in higher cost oil sands and oil shale deposits. There is enough oil to supply the growing demand for decades.

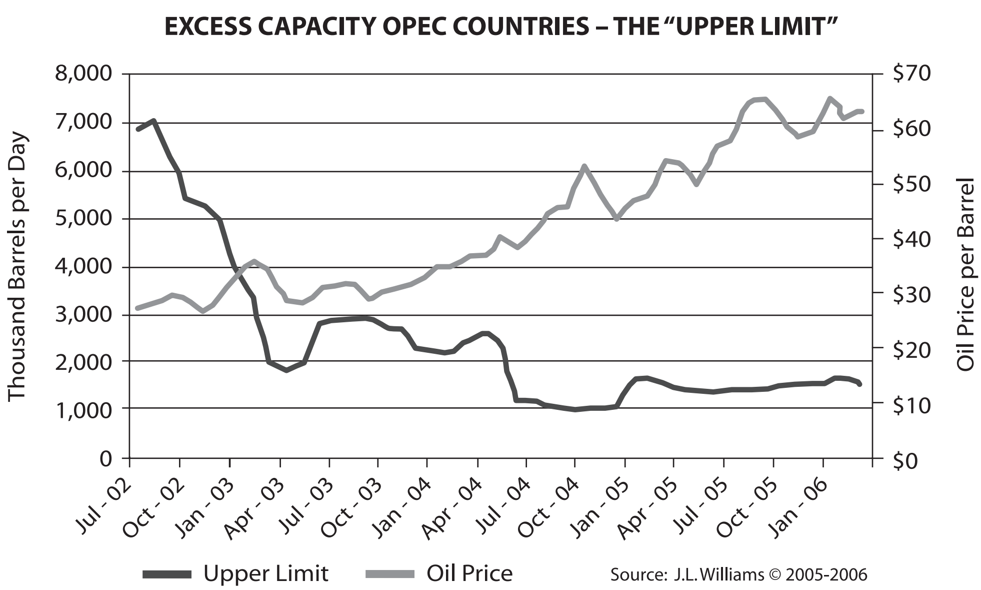
Oil, Like All Commodities, Responds to Price

The new supply will come, with a time lag, just like in the past. The following chart shows non-OPEC production in grey and the oil price in black. See how rising prices in the 1970s and early 1980s led to big production increases. This jump in competing barrels forced OPEC to slash production in half in the early 1980s.



Finally, Saudi Arabia concluded that its market share loss was big enough, so OPEC oil production was increased. This drove the price of oil down, causing the decline in non-OPEC volumes that you see in the mid-1990s.

Fast-forward to today and OPEC's production – after getting cut to stabilize prices in the late 1990s – is back to the peak of the early 1980s (see chart above).



The oil price bulls see the previous chart, showing a big drop in OPEC excess capacity, and salivate: "This must mean that OPEC's production has peaked." We don't believe it. OPEC has had huge excess capacity for over two decades and didn't need it. Now that they do, drilling in places like Saudi Arabia is ramping up and volume growth will follow.

Even Exxon Mobil (a perennial oil price bear that has preferred to buy back its shares rather than increase exploration spending to drive higher volume because it felt US$18-20 per barrel was the long-term equilibrium price) is investing in expansion. Exxon has just announced that it will increase spending to $100 billion over the next five years, which should bring its own huge volumes up almost 5% per year. And output from Canada's oil sands, currently at 1 million barrels per day, is forecast to hit 3.5 million barrels by 2015.

Analyst Daniel Yergin at Cambridge Energy Resource Associates added up all of the oil projects underway today, field by field. His conclusion: The world's production will see its biggest surge ever over the next five years. And these projects are funded and in development. Is adding 15 million barrels per day, or a compound annual growth rate of 3.3%, enough supply, given the huge growth in China?

Yes! Out of 85 million barrels a day in global demand, China accounts for 7 million, but only 30% of this is for transportation. The bulk is for power generation. About eight years ago the Chinese authorities began the biggest expansion of coal-fired power plants in history, culminating today with a new one being opened every month. After seven years of electricity shortages, by sometime next year China will actually be producing a surplus of electricity. So yes, its transportation demand for oil will rise. But it will be offset by reduced electricity demand as the new power plants come on stream.

The world also uses less oil per unit of GDP each year. This is from continual improvements in technology and energy efficiency. And it holds true in both the wealthy OECD nations as well as the non-OECD countries.

This is why the compound growth in demand over the next 25 years is expected to be only 1.6% per year.

So the math is simple. Over the next five years, with supply growing at 3.3% per year and demand at only 1.6%, it is a matter of when, not if, the oil price cracks.

So why are oil prices hitting new highs, despite U.S. inventories being the highest since May 1998, which was just prior to the crude price hitting US$10 per barrel? It's not supply and demand. After global energy meetings in Qatar last week, Saudi Arabia's oil minister stated that "nobody is asking for additional crude," [82] and this from the world's biggest exporter. Even U.S. Energy Secretary Sam Bodman stated that oil markets are well supplied.

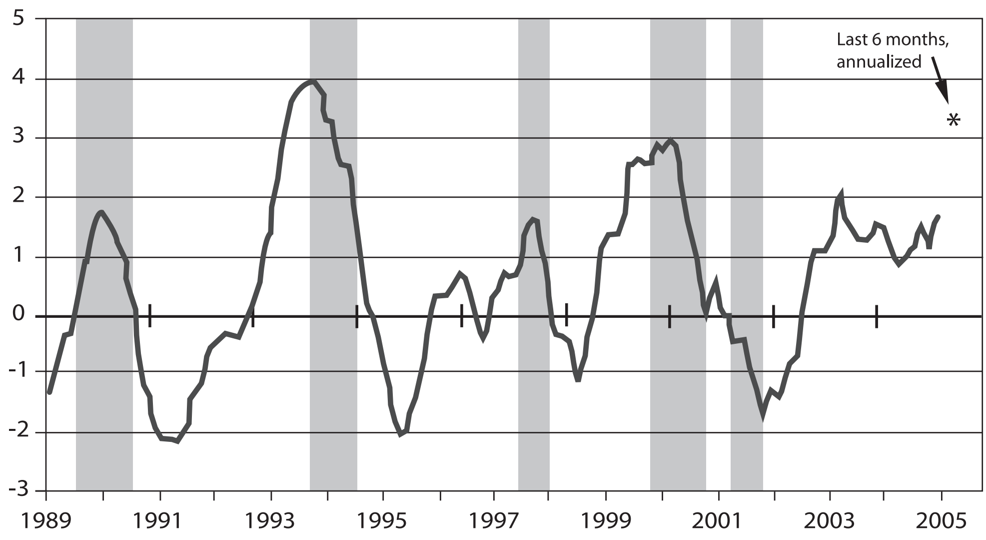
A significant premium in the oil price comes from a big hedge fund impact. Analyst William "Buff" Brown, the president of WHB Energy Research, after analyzing the historical effect on pricing from inventory and the purchases of forward contracts, estimates that the oil price impact of financial speculators is US$23.20 per barrel. And this is just from investments in commodity index products in the last two years. With no income from this direct oil exposure, and lots of volatility, these fast money buyers will eventually be sellers.

So our conclusion: With all commodities trading way above their marginal cost of production, a big slick is coming in oil, and a big downside in all other commodities. Economics 100 will work. Lower demand and massive new supply will be the response to today's great prices. It is simply a matter of when.

Here's a final clincher. As Warren Buffett likes to say: When playing cards, if you don't know who the patsy at the table is, it's probably you. Well, historically, foreign buyers of Canadian stocks have been the patsy. They bought gold stocks after they doubled in 1993, tech stocks at the top in 2000, and commodity stocks today. They seem to epitomize the five-year psychological cycle.

UBS published a report two weeks ago highlighting that foreign purchases of TSX stocks have crept up to 3% of market value. As you can see from the line and black star, this is typically a peak level.

STRONG FOREIGN INFLOWS
(line, rolling 12 month sum as % of market cap)
have preceded TSX declines of 10% or greater [shaded]



Source: Statistics Canada, S&P, UBS

You can also see by the shaded areas that almost all big drops in the TSX have started when foreign buying has been at its strongest. Bill Miller might say that the foreign buyers' investment thesis goes something like this: Yes, commodity prices are high, and so are commodity stocks... and they will stay this way longer than normal... before we lose your money.

That sounds to us like a recipe for some asymmetric negative returns.

Author: **David Vanderwood, Senior Vice President and Portfolio Manager for Canadian equities**

May 2007

Reflections from the Funhouse

Top corporate managers and elite investors both specialize in capital allocation. Whether in the corporate sector or in securities investments, the most successful capital allocators follow some surprisingly similar behaviour patterns. When confronted with an overwhelming number of investment choices, they step back, assess the commercial realities they face, and then define the strategic orbit within which they, or their organizations, can outperform over the long term. Success flows from that process. In this *View from Burgundy,* we will delve into how the best managers set such boundaries. Using the same principles, we will then offer suggestions on how to frame investment decisions so that better choices can be made.

Legg Mason's Michael Mauboussin became intrigued with the success of a small number of securities investors who had generated excess returns for their clients over a very long-time horizon.[83] He found some interesting similarities in their approaches: all of these successful investment firms adhered to a "value" approach, tended to hold a limited number of stocks, and held their positions for a long time.

Most "professional investors" do not behave this way at all. They handle the mind-boggling array of investment options by spreading their bets widely and jumping around among holdings at a dizzying pace. Consider this: the average mutual fund's annual turnover is more than 110% today versus only about 20% in the 1960s. And since these funds tend to hold a large number of positions (more than 100 is probably normal) this means that, on average, they are selling and replacing more than two positions per week. Of course, many managers transact much more frequently.

Incidentally, clients are not much more disciplined than their own professional managers. Today, the average mutual fund holders only keep their units in a given fund for about 30 months, compared to an average of more than 10 years in the early 1970s. Managers and clients alike are constantly distracted by the noise, the information overload, and the sheer volume of choices presented by today's inordinately complex capital markets.

And these shareholders have a pronounced effect on the managements of the companies in which they ephemerally "invest." With this hyperactivity of investors has come a demand for short-term gain that places huge pressures on managements of public companies to do something, whether that something is an acquisition, a stock buyback, or a disposition of assets. Given their normal empire-building instincts, corporate managers are always trolling for deals and looking for ways to offer short-term gains to shareholders. They too face a huge variety of choices, and they do not always choose wisely.

A recent book focused on the subversive nature of having too many options and too many opportunities to choose from. This book, *The Paradox of Choice: Why More is Less*, by Barry Schwartz, concludes that having almost unlimited options encourages people to make too many decisions, and to feel worse about the ones they have made. In turn, this propels people to change their minds a lot, leading to a vicious cycle of change and regret. Mr. Schwartz's book focuses on daily life and its many decisions, but it has obvious applications for investors and corporate managers.

From watching Warren Buffett and the other great investors on Mr. Mauboussin's list, we know that the surest way to create wealth is to follow a consistent value approach. Such investors own a limited number of high-quality companies for a long time, preferably after buying them cheap. Yet Mauboussin has concluded that only about 8% of public funds are managed in this fashion.[84] Why is this approach practiced so rarely?

The answer, according to Mr. Schwartz, is that maintaining discipline in a world of promiscuous choice is really hard. There are elements of human nature that seem to militate against intelligent restraint. Superior investors are doing something that others cannot or will not do. They are defining and remaining within boundaries, within which they can outperform over the longer term. Buffett calls these boundaries a circle of competence.

The Best Investors Stay Within a Circle of Competence

Staying within a circle of competence implies that choices will be limited. The outer limits are pretty clearly defined. No investor can be all things to all people, nor is anyone capable of valuing all securities. Investing money without investing adequate time to truly get to know the inherent risks will often lead to permanent capital losses. Staying within a circle of competence forces focus on a limited number of investments and leads to the steady accumulation of knowledge about a business and its inherent risks. As the value investors on Mr. Mauboussin's list have shown, this necessarily long-term approach can be a recipe for great long-term returns.

What behavioural issues make value investing so difficult? There are several, all of which flow from the many paradoxes that define human nature. At one extreme the human mind is unique in the animal world for its ability to plan for the future. This has allowed for huge advances, technological and otherwise, and it has also given us an imagination, which differentiates humans from others in the animal kingdom.

On the flip side, our brain is poorly designed when it comes to dealing with fast-changing capital markets. Humans can be at the same time overconfident and paralyzed by uncertainty. Our physical response to stress, which manifests itself as fight or flight panics when faced with surprise, has evolved to prepare us for the short term. The human mind's systematic contradictions cause most of us to fail when making long-term decisions in conditions of uncertainty.

So nearly everyone has a time horizon that is too short to deal intelligently with the capital markets. Most market participants chase the same "timely" investments, whose popularity bids up their prices. Low subsequent returns are the result. Cheap stocks get cheap precisely because they are unpopular. Since there is rarely an obvious catalyst to close the gap between intrinsic value and price, the timing of value realization is unpredictable. Value investing is a get-rich-slow approach that rewards patience above all, a quality that human nature ensures is in short supply.

Value investing is also unpopular because it comes with social pain. The best investors all concur that being in a small minority is necessary for an investment to be a big win. Yet human evolution has programmed us to feel unsafe and uncomfortable when we are alone, and most people cannot stand to remain that way for long. It is infinitely more comfortable to be part of a crowd than to be alone. Again, we see an intense pressure towards the short term.

In addition, most investment firms that adopt the value discipline assume a lot of business risk because so many clients and potential clients compare short-term performance to an index or other benchmark. Value investors' portfolios look nothing like an index, so there are inevitably periods of time when the investment results do not compare well to the benchmark. And the end-date sensitivity of returns means that most clients can deceive themselves into believing that a manager has done badly for a long period, when it may be only one poor year relative to the index that distorts the returns. A lot of business can be lost in such years and the principals of most investment firms conclude that the cost of a long-term time horizon is simply too high to bear.

Human nature being what it is, defining and remaining within a circle of competence is much harder than it looks. The necessary disciplines, such as long-time horizons, a willingness to undergo social ostracism, and acceptance of lost business in "out periods," are too difficult for most investors to follow. That is why value investing is practiced by only a minority and why the long-term payoffs are so great.

The best corporate managers tend to apply a lot of the same disciplines as value investors do. They set and stay inside boundaries for the company's activities. But these boundaries are to some extent naturally dictated by the company's business position. The rough boundary is defined by the barriers to entry that a business possesses.

The Best Companies Use Barriers to Entry to Define Their Circle of Competence

Barriers to entry are structural forces that prevent new competitors from entering a market and eroding profitability. Warren Buffett calls it a moat around the business. Companies operating in this protected position are able to generate high returns by doing things that competitors cannot or will not do, much like the circle of competence used by the best investors.

Although there are important similarities between the two circles, there are also differences. Note the defensive implications of the words "barriers" and "moats." While the implication of a circle of competence is one of staying inside, a barrier to entry implies keeping threats out, since it is in the nature of capitalism to erode entry barriers and eliminate excess profits in most circumstances. Investors need the discipline to stay within a circle defined by their understanding of economics and businesses; the corporate managers need the discipline to stay within an economic fortress defined by their business. So the two are mirror images of each other, where the mirror is slightly curved, like those found in the funhouse at a carnival.

The best CEOs of companies with moats share a critical insight: a durable barrier to entry is a scarce and extremely valuable asset. There is an important corollary – don't stray outside the moat. Because competitive advantage only exists in areas inside the moat, investments outside the moat face a high risk of failure. Yet business history is rife with tales of companies that have wasted the shareholders' money making undisciplined forays across the drawbridge. (Just think of Time Warner's catastrophic merger with AOL, or BCE's disastrous acquisition of Teleglobe.) The same behavioural issues plaguing investors are evident.

Most investors and CEOs alike, being human, default towards behaviour with a focus on the short term. Just as investors are under pressure from competitors, clients, brokers and consultants to participate in booms and diversify beyond the circle of competence, managers are under pressure from short-term shareholders, investment bankers and competitors to do something. Too often that "something" involves making dramatic strategic moves outside the moat. Moreover, with the tenures of corporate leaders getting shorter every year, there is an intense pressure to cash in during this brief period at the top. As a result, the behaviour of CEOs often reflects that of typical high-turnover professional investors. These shareholders get the CEOs they deserve, and vice versa.

The appropriate time horizon for an owner is forever. We have often seen the best long-term corporate performance come from family-controlled companies, where the CEO is fully aware of this enduring planning horizon. The typical hired-gun manager, like the typical investor, is under tremendous temptation to behave very differently. In our experience, they do not often resist the temptation successfully.

At that small minority of investment firms and companies that consistently outperform the long-term averages, the leaders resist these pressures in a similar way. They define and remain within a circle of competence. The best investment firms use a value approach to set the boundaries, while the CEOs of the best companies use barriers to entry to outline their limits. Adopting this discipline is the only way to ensure that a long-term planning horizon will be used.

So the key to having the patience to make long-term decisions is discipline. In that way, companies and investors are linked. Company CEOs need patient investors who give them the time for long-term decisions to bear fruit. And investors need patient CEOs to make the tough decisions in the best long-term interest of the owned companies. From this virtuous circle investment success can follow.

We have mentioned Mr. Schwartz's book *The Paradox of Choice* before. His focus is the problem of intelligent decision making under conditions of minimal constraint, and the psychological effect of that "free choice" environment on most people. His book looks at the modern American consumer as the avatar of this trend, and places widespread feelings of helplessness, depression and self-blame squarely at the door of an environment that provides too many choices. He concludes his book with a number of decision rules to help people deal with their complicated daily lives. We found several of his decision rules so applicable to the world of corporate and securities investing that we adapted them for this article. The four that are most germane to our theme are included here.

1. Learn to love self-imposed constraints. Most people might be surprised by this rule since they may feel that value investors must have unrestricted access to any area where value can be found. But the success of the best investors and CEOs is achieved within very stringent, self-imposed constraints. Mr. Schwartz classified these constraints in several categories: in declining order of stringency, they are rules, standards, and presumptions.

One rule comes before all others. Never invest outside the circle of competence. This rule is self-perpetuating, since it forces the manager to define the circle of competence carefully. For corporate managers, the rule should be to focus as much as possible within the moat around the business.

An example of standards would be the constraints under which Warren Buffett invests. He uses not only stringent standards of barriers to entry and high returns on capital, but also assessments of management character and capabilities that he is uniquely equipped to make. Simply by stating at the outset that his minimum standards do not include lower quality, marginally profitable or outright speculative companies, Buffett is left with far more time to spend learning about the outstanding businesses that make the cut.

A corporate minimum standard might be to undertake no investments that earn less than the cost of capital, using extremely conservative assumptions. While not rocket science, this management discipline is about as rare as outstanding companies, which suggests it is worth thinking about.

For a corporate manager, a presumption might be that since acquisitions generally subtract value, none will be made. Since presumptions are less restrictive than rules, they leave more room for exceptions. In a rare case, such as an in-market merger that builds economies of scale, an acquisition may be an excellent opportunity.

A presumption for an investor may be that what he already owns and knows well is a better investment than something new. Again, this presumption can be abandoned when valuation or opportunity dictate, but it is a useful starting point.

2. Be a chooser, not a picker. Mr. Schwartz states that "choosers are people who are able to reflect on what makes a decision important, on whether, perhaps, none of the options should be chosen, and on whether a new option should be created." [85] Every investment decision should be important, and they will be if investors restrict the number of decisions.

Warren Buffett has said that everyone should make their investment choices as if they were only allowed to make 20 investment decisions in a lifetime. Choosers are like baseball players who can take the time to sit back and wait for the fat pitch. After they "swing" and make the investment under the most favourable possible conditions, their only job is to continue to learn about the business in which they have invested, keeping a wary eye on competitors, regulators and customers for signs of eroding barriers to entry. This monitoring is not nearly as exciting as switching into something new and fresh. In fact most people find it deadly dull. Daring to be dull is not something most people want to do, but it can lead to big rewards in the long term, as Mr. Mauboussin has shown.

Choosers that stick to high standards of quality and valuation will avoid bubbles and cycles to a significant degree. As Mr. Schwartz observes in another context: "Only choosers have the time to avoid following the herd." [86] Taking that time is critical to capital preservation. Somehow the number of people who hang on to any of the money generated from bubbles and cycles is pretty small.

Instead, when faced with a plethora of choices and a cacophony of noise, most market participants become "pickers" who select relatively passively from whatever options are available. They spread their bets widely and jump around. Decisions become reactive, as surprising information is constantly forthcoming that overwhelms their limited understanding of the situation. It's pretty clear to which category an investor should seek to belong.

3. Presume that your decisions are irreversible. What would investors do if told the stock they were buying could never be sold? They would take some care with the decision, wouldn't they? They might even start acting like "choosers" with all of the concomitant benefits.

Note that this is a presumption, meaning that in cases where a company's moat starts shrinking (a common occurrence, by the way) the holding could be sold. But we would still contend that assuming an indefinite holding period is the best place to begin framing investment decisions.

For CEOs the same reasoning applies. The big strategic choices will be given the appropriate time and analysis if it is presumed they are irreversible. Relying on investor amnesia to consign past errors to oblivion is not an effective strategy for a manager who wants to excel. Writedowns of past errors may disappear from the financial statements immediately, but they are not victimless crimes.

4. Curtail relative comparisons. Ignoring what others are doing at any given time removes the "grass is greener" effect from decision making. While always a useful prescription for investors, it is particularly so during peaks, troughs and bubbles in the market, when maintaining discipline is most difficult. Independent thinking will give better conclusions in any situation. But it is a rarity in corporate life and in the capital markets.

We have all witnessed the tendency of investors and companies to do what their competitors are doing – especially in boom times. The two disasters we referred to on page 298, by Time Warner and BCE, both occurred during the tech bubble, when these companies decided that their stable, powerful, profitable and unexciting core businesses needed to merge with dynamic new businesses of unproven worth. And most money managers in that period were behaving the same way, looking for excitement and popularity rather than for quality and reliability. Those who stayed focused did their shareholders and clients a great favour.

Warren Buffett advises investors to completely ignore conventional wisdom. By the time it is conventional, it is rarely wisdom. It simply does not matter if others agree or disagree with your conclusion. What matters is that the analysis is correct. The same holds true for corporate strategy.

It does make sense to keep track of how the winners are defining their boundaries. But it is best to curtail peering over the fence to see if in the short term you are keeping up with the Joneses. Behavioural finance theory suggests that the optimal period between reviews of your portfolio should be 13 months. Very few of us could say we obey that rule!

Decision rules to frame investment decisions:

1. Learn to love self-imposed constraints
2. Be a chooser, not a picker
3. Presume that your decisions are irreversible
4. Curtail relative comparisons

Using these four rules of thumb can help investors and CEOs define the boundaries of a circle of competence. This is one way to withstand the intense pressure towards adopting short-term planning horizons that is caused by deep-seated behavioural issues. The best CEOs and investors are doing it already. It is called discipline.

These investors and corporate managers need each other, because a CEO cannot make long-term decisions without the support of long-term shareholders, and an investor cannot generate superior returns without owning companies run with long planning horizons. Thankfully, it is easy for each to recognize the other. The reflection staring back from the funhouse mirror is a person with a really long-term time horizon, the only appropriate view for investment success.

Author: **David Vanderwood, Senior Vice President and Portfolio Manager for Canadian equities**

June 2009

The Year of the Turkey

Richard Rooney, President and Chief Investment Officer at Burgundy Asset Management Ltd., delivered the following speech on the occasion of the firm's Client Day, April 23, 2009.

Have you ever watched the "talking head" interview shows on financial channels like CNBC? Usually they are structured with several guests who agree with each other, and one who has major or minor differences from the majority. You may have noticed that when minority guests have very large differences of opinion, they run the risk of having their opinions treated with incomprehension or outright contempt. In 2006 and 2007, those who went public with their fears for the U.S. mortgage bubble and the likely effect on the financial system were often treated this way. Likewise those brave souls who questioned the tech mania in 2000 and the commodity bubble in 2008.

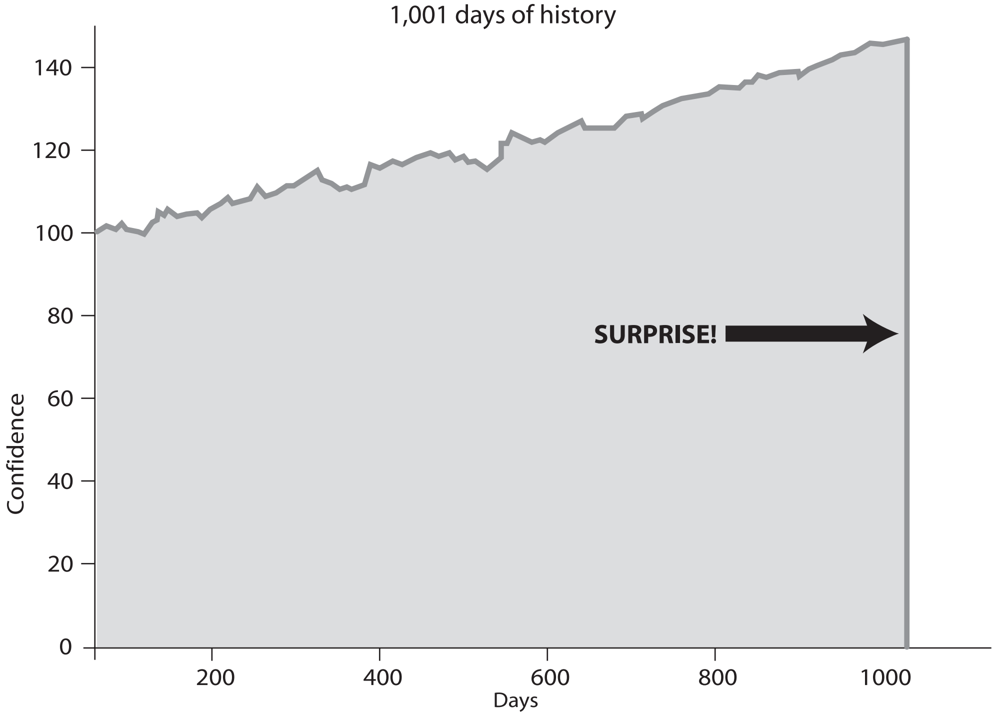
At market extremes, there is an almost Stalinist drive towards conformity of opinion among market participants. The consensus at such times is supported by long trails of strong returns, so that anyone expressing doubts or suggesting alternatives is espousing what appears to be a demonstrably inferior approach. Besides, all our instincts tell us to agree, to go along, that there is safety in numbers. In the small hunter-gatherer communities that we lived in when these instincts were formed, that was usually true. But in the capital markets, it can be disastrously wrong. In the capital markets, as conformity takes hold and confidence increases, so does danger.

Nassim Nicholas Taleb has written a very entertaining book called *The Black Swan* about risk, uncertainty and the highly improbable. He has an illustration of misplaced confidence that I think is particularly apt today.

Following is a graph of the confidence level of a turkey in the good intentions of its owner.[87] Over three years, as the turkey is housed, fed and given free medical care, its level of trust in these good intentions grows steadily, peaking just before Thanksgiving. At that point, its assumptions are challenged.

A TURKEY BEFORE AND UP TO THANKSGIVING

1,001 days of history



Source: Illustrative concept taken from *The Black Swan*

With apologies to the Chinese calendar, 2008 was the Year of the Turkey. Our assumptions on many levels were challenged, and often disproven. Today I want to discuss what we learned in 2008 about risk and uncertainty in the markets. I will show how our process is designed to protect us from the dangers of consensus, and why in some areas it did not do so in 2008. I will explain how and why we are positioned as we are in 2009.

Beware of Consensus Investing

Two years ago, I discussed in my presentation Michael Mauboussin's analysis of opinion diversity as the key to efficiency in the capital markets.[88] When a consensus forms, opinion diversity declines and valuation in the markets gets out of whack. The more powerful the consensus, the more distorted the valuations and the more dangerous the consensus play becomes.

At Burgundy, we feel our valuation approach and philosophy protect us from the worst excesses of consensus investing. This protection was most purely on show in the tech bubble period, when valuations were crazy and not owning tech shares led to massive excess returns when the consensus unravelled.

More recently, a major consensus emerged in the cyclical stocks. The BRIC (Brazil Russia India China) market growth story, with its Malthusian implications, became almost unanimously held and led to substantial outperformance by commodity producers over a period of years. By mid-2008, cyclical stocks were the most highly valued they had ever been, and nemesis followed. As usual, Burgundy was very early in exiting these stocks, but we protected the downside when commodity prices and stocks crashed in the second half of the year.

However, there was another, more insidious consensus underlying the financial markets over the past 25 years. A long period of benign conditions meant that very few people were attuned to deep-seated problems in the financial markets themselves. By the beginning of 2008, interest rates had completed a 25-year decline. Housing prices had been rising steadily for 60 years, in all kinds of macro environments. Securitization had created massive new markets where none had existed before. Economists spoke of the "Great Moderation" as financial assets appeared to have settled into a pattern of low volatility and steady price increases. The capital markets were turkeys on Thanksgiving Eve.

Now, aside from the superb performance of our Asian Equity Fund, I would not classify Burgundy's performance in 2008 as good, or even acceptable. Although we usually outperformed the benchmarks and most other long-only managers, and although declines in our portfolio values were more than reversible, we will never look at a negative number as satisfactory. But, we did avoid the worst of what happened in that awful year.

I believe that is no accident. I think the way Burgundy approaches investing makes us less likely than most to be Thanksgiving dinner. This has to do with the way we distinguish risk from uncertainty. Let me elaborate.

According to economic theory, risk describes a situation where you have a sense of the range and likelihood of possible outcomes. Uncertainty describes a situation where it's not even clear what might happen, let alone how likely the possible outcomes are. Trying to distinguish between the two is a primary task of investors.

Mediocristan vs. Extremistan

Again, Taleb's book provides a useful illustration. He divides the world into two realms: Mediocristan and Extremistan. In Mediocristan, normal statistical distributions apply; in Extremistan, they do not. In Mediocristan, there is risk; in Extremistan, there is uncertainty.

For example, if you filled the Rogers Centre with randomly selected adults, their heights and weights would fit within a normal distribution. You could wager with near certainty that nobody more than eight feet tall or less than two feet tall would be in attendance.

But if you measured their wealth rather than heights and weights, you might get a very different picture. If Warren Buffett or Bill Gates were among the sample, their wealth alone would dwarf that of all the others combined. If wealth were normally distributed, the likelihood of anyone ever being as rich as Warren Buffett or Bill Gates is infinitesimal, but in fact capitalism routinely produces superwealthy individuals at a rate many times the frequency predicted by normal distributions. So if you wagered that the net worth of your sample would be a normal distribution, you would be right very often, but would be running a substantial risk of being very wrong. Height and weight are in Mediocristan; wealth is in Extremistan.

The whole thrust of academic finance for two generations has been to apply normal statistical measurements to the capital markets, or in other words, to pretend that the markets are in Mediocristan. Modern Portfolio Theory defines risk as volatility, and volatility is assumed to occur within normal statistical bounds. Most derivatives were designed with that principle in mind, as were most quantitatively derived portfolio structures. The horrifying results of these assumptions are all around us in the wreckage of the "alphabet soup" of CDOs, CLOs, ABCPs and ARSs manufactured on fallacious statistical grounds, whose price collapse has savaged the world's financial system.

Burgundy, on the other hand, has always defined risk as the risk of absolute capital loss, of being wiped out. Integral to our thinking is the fear that we may be in Extremistan with any investment. Irreversible capital losses, such as those suffered by "alphabet soup" investors in 2008, are the hallmark of investing in Extremistan, where, as they say, the tails are fat. The task of the prudent investor is to minimize, to the degree possible, the likelihood of such losses.

At Burgundy, we do so by drawing a distinction between the uncertainties inherent in the market, and those in the companies we invest in. The capital markets can price any security at any level on any day, so I agree that they are in Extremistan. But think about the kinds of companies in which we typically invest: they have frequent transaction cycles, large numbers of customers, broad-based distributions, international diversification and so on. This means that to a significant extent, our businesses compete in Mediocristan, where things are a great deal more predictable than in Extremistan. The market values that are set in Extremistan fluctuate, but the business value that occurs in Mediocristan does not. To translate that idea into Burgundy's terms, the business value is the equivalent of our intrinsic value. The difference between the market price and that business value is our margin of safety.

A brand name global consumer franchise undertakes uncertainties in more manageable quanta than a mining company with properties in Venezuela, or a construction company with a huge project, or an investment bank. All businesses undertake the dangers of regulation, political intervention, product obsolescence, operational disruption and systemic breakdown. The combination of all these things leads to uncertainty, and uncertainty can never be completely banished from any investment. But uncertainty can be diminished by the inherent nature of the business. Businesses with some inherent predictability are what we look to invest in at Burgundy.

Decline in Financial Sector

No doubt you are saying to yourselves, if all that is true, why did we see substantial declines in value in some Burgundy portfolios in 2008? The reason is that there was an area where we were investing in Extremistan to a degree we did not appreciate until damage had been done. The investments we made in the financial sector cost us dearly.

These investments were concentrated in Europe and Canada. Craig Pho, our Asia manager, has never had much exposure in financials, no doubt because Asia has experienced several financial crises in the past two decades, so he was naturally suspicious of big banks and insurers. Stephen Mitchell deserves a tip of the hat for smelling smoke from the U.S. financials and exiting them before much damage was done. But we did not appreciate the dangers of international contagion until we had taken some losses elsewhere.

In fairness to our Canadian and European teams, who acted with my full support, we were looking for financials whose characteristics we thought were indicative of a Mediocristan situation – strong deposit bases, diversified product profiles and oligopoly positions in multiple markets. None of that mattered in 2008. In a globalized financial system, all financial businesses are related and all their stocks are correlated. And it turns out there was a lot we didn't know about the balance sheets of the banks and insurance companies coming into this crisis.

We now have the smallest investment in big balance sheet financials we have had since the late 1990s. That is in part because in this indiscriminate bear market there has been a lot of opportunities to buy high-quality, simpler and more predictable businesses. But it is also in part because we have had a forceful reminder of the inherent uncertainties of the financial sector. These investments cost our clients a lot of money in 2008 and for that we are sorry. We learn backwards; we live forwards.

The New Consensus

Speaking of living forwards, how are most investors looking at the world today? Today the consensus among most investors is a bearish one. The bear narratives are supported by terrible trailing returns and will continue to be until at least the end of 2009. That's just math. Every time the markets lurch lower, the bear case finds more adherents. The Elgin Theatre was sold out for a forum called "An Evening with the Bears" in early April. The state of opinion in the markets still shows a remarkably bearish tinge, though the extreme panic of early March has abated somewhat with rising equity and corporate bond prices.

The main problem the bears have is that they can't decide what kind of disaster is about to befall us. Some feel we are facing a deflationary depression like in the 1930s; or at least like Japan's. Others feel we are on the cusp of hyperinflation. It reminds me of that memorable Woody Allen proverb:

"More than any other time in history, mankind faces a crossroads. One path leads to despair and utter hopelessness. The other, to total extinction. Let us pray that we have the wisdom to choose correctly."

Surprisingly few of the people who are most bearish now actually saved their clients any money in 2008. Many of the bears decided that the safe place was outside the U.S. in commodity plays, and lost their clients 40–60% in 2008, sometimes even more. Warren Buffett calls it the Noah rule: predicting rain doesn't count; building arks does. I honestly admire some of these bears for their courageous and lonely stance in 2006 and 2007; but while Burgundy didn't do as good a job as these folks at predicting rain, we built a better ark than they did, because we used better materials.

Superior Valuation

The only thing all the bears currently seem to agree on is that you shouldn't touch equities. Outside some specific commodity plays they are virtually unanimous about that. We, of course, disagree. So once again, we find ourselves positioned against the consensus. And once again, our positioning is based on our most reliable support – superior valuation.

Valuations of high-quality equities are extraordinarily low; and therefore, we are fully invested and holding our weightings in equities at maximum levels. Global brand name companies are the best value we have ever seen. For the first time in decades, both Ben Graham-style investors (who emphasize low price-to-earnings ratios, high-dividend yields and strong balance sheets) and Warren Buffett-style value investors (who tend to add qualitative assessments of economic advantage to traditional valuation measures) are investing in these global consumer franchise companies. So Ben Graham purists like Prem Watsa (who got both the diagnosis and the prescription right last year) and Jim Grant (editor of *Grant's Interest Rate Observer* and two-time speaker at Burgundy's Client Day) are buying the same kind of stocks as Warren Buffett and Charlie Munger. Given the track records of these two major schools of value investing, it is very exciting to see them converging in their stock picks. We expect good news.

No Turkeys Here

Investing in the face of irrational valuations caused by runaway consensus in the markets has been the most salient characteristic of the past decade. We have arguably seen more powerful and virtually unanimous consensuses form in that period than in any previous decade of the last century. It is ironic that in an era where infinitely more information is available to the average investor with an Internet connection, than I ever had access to for the first 15 years of my career as an investment professional, there seems to be less rather than more diversity of opinion in the capital markets. Behaviour is absolutely lemming-like.

Burgundy has a generally positive and honourable report card from its behaviour at market extremes when consensus rules. I have been very proud of the character and firmness shown by our people in the face of relentless negative feedback from the rest of the financial community at these times. We have never wavered in applying our investment philosophy and approach, and have generated a superior track record. We can always do better of course, and will always try to, and we are frustrated as you are with the level of absolute returns. But with portfolios of strong and predictable businesses selling at outstanding valuations, and with a powerful and probably mistaken bearish consensus opposing us, we are confident that there are no turkeys in this room.

Author: **Richard Rooney, President and Chief Investment Officer**

2010 – 2014

2010
European debt crisis hits

2012
Abenomics in Japan

2013
Pro-Europe protests destabilize Ukrainian government

July 2010

Growth That Matters

In this issue of The View from Burgundy, *we return to a couple of familiar themes: the paramount importance of capital allocation to long-term returns, and the opportunity to invest with outstanding managements in the province of Quebec.*

Read any publication by the Harvard Business Review or McKinsey and you are sure to see articles advising executives on how to grow their business. Most of this advice stresses rapid revenue growth and business expansion. But does growth actually matter? Very often these growth strategies do not result in good returns for shareholders. Growth absolutely matters, but as BMTC (a Quebec-based furniture retailer) shows, the only kind that matters is growth in per-share intrinsic value.

BMTC is a leading furniture retailer in Quebec operating under the "Ameublement Tanguay" banner around Quebec City and the "Brault & Martineau" banner elsewhere in Quebec. From 2000 to 2009, BMTC's total shareholder return was 1,300% (30.2% per year) compared to just 73% (5.6% per year) for the S&P/TSX Composite Index. While $1 million invested in the Index turned into about $1.7 million a decade later, the same $1-million investment in BMTC would have turned into more than $14 million (eight times more). How did the company do it?

Was It Revenue Growth?

Normally when retailers are successful they build more stores and increase their revenue per store. Throughout the decade, BMTC expanded from 19 to 26 warehouse stores and also built six new small-format mattress stores. Revenue per store was essentially unchanged. Combined, this resulted in revenue growth of about 51%. Not bad, but it only accounts for 13% of the total return so there must be more to the story.

Was It Multiple Expansion?

One of the fundamental concepts of value investing is that when a stock is out of favour, it often trades at a low earnings multiple. When it becomes more popular, the earnings multiple usually increases. Did BMTC benefit from multiple expansion? Yes, but minimally. The stock traded at just 7.8 times earnings in late 1999, and the multiple expanded slightly and ended 2009 at 9.6 times earnings. The expanded multiple contributed 6% to the total return.

Was It Margin Expansion?

By controlling costs, it is possible to grow profits faster than revenue. In 1999, BMTC earned $18.5 million in profit at a 3.4% profit margin. This was much lower than the 9.8% profit margin at Leon's, one of the best-managed furniture retailers in North America. By 2009, BMTC had more than doubled margins to 8.2%, in line with Leon's 8.1% margin. If BMTC's margins had stayed the same, the company would have earned $27.8 million in 2009. But, thanks to efficiency gains, it actually earned $67.1 million. So efficiency gains are a big part of the answer, but still only account for another 35% of the total return. What else could have contributed to that enormous 1,300% return?

Was It Capital Allocation?

Capital allocation is broadly defined as what management does with the money it has. The most common options are investing in growth (opening new stores, etc.), acquiring other companies, reducing debt, paying dividends and buying back stock. BMTC didn't have any debt during the decade and, as we've already pointed out, they didn't open very many stores. How did they choose between the remaining options? BMTC didn't make any acquisitions; instead, they chose to pay dividends and buy back shares. The dividend was responsible for about 3% of the total return.

Which Only Leaves Buybacks…

Many companies buy back their own shares consistently, regardless of price. But BMTC was acutely sensitive to price, spending as little as $9 million (in 2000) and as much as $80 million (in 2008) to buy back shares. The key is that they only bought back stock when it was cheap.

Consequently, BMTC was able to reduce its outstanding shares by more than 50% during the decade. In other words, continuing shareholders were able to double their proportionate ownership without spending an additional penny. Opportunistic buybacks were responsible for a whopping 43% of the total return.

To summarize, in December 1999 you could have invested in Leon's, a good business with great operators, at a reasonable price (14 times earnings) and made a 120% return – 30% more than the TSX. Or, you could have invested in BMTC, a good business with great operators and great capital allocation, at a reasonable price (8 times earnings) and earned 1,300%. Assuming an initial investment of $1 million, you would have made an extra $11.8 million during the decade by investing in BMTC. That's how valuable great capital allocation can be.

Growth That Does Matter

The way investors get returns from equities is through increasing stock prices and dividends over time. That, of course, is growth.

Most investors are simple-minded about the sources of growth. They see companies that increase their top line rapidly or that undertake aggressive acquisitions as the best candidates to produce strong shareholder returns. In fact, these companies are very often buying top-line growth at the expense of lower margins or ruined balance sheets. Such strategies are always counterproductive and often disastrous to the long-term shareholders of the firm.

The case of BMTC is an unusually clear illustration of the kind of growth that really matters: growth in per-share intrinsic value. This kind of growth can come from any or all of the traditional sources of capital allocation – intelligent capital expenditures, prudent acquisitions, appropriate dividend increases or timely and opportunistic stock buybacks. BMTC did not use acquisitions, but was very shrewd about its capital expenditures and dividends, and positively brilliant in its stock repurchases. In Burgundy's experience, this is a very rare combination.

BMTC's owner-managers were able to make outstanding repurchase decisions about their stock because they did not care about what Bay Street thought (investment bankers always recommend against small-cap companies repurchasing stock on the basis that lower trading volume is bad for returns). Whenever BMTC managers thought that BMTC stock was attractive to them as rational investors, they bought it. And when it was really attractive, they bought a lot of it. The purchases increased their personal percentage ownership positions, and dramatically increased the value of the remaining shares.

Quebec's small-business community is full of tough-minded mavericks like the BMTC managers. Ironically, they have been far better stewards of shareholder capital than most companies with investor relations departments and big "incentive" plans that allegedly align management with shareholders. The simple reason: they act like owners because they are owners, and owners are the most rational actors in the capital markets.

It should be no surprise, then, that Burgundy prefers to invest alongside managers with big ownership stakes. Long-term shareholder returns can be outstanding (as the BMTC example shows) when superior capital allocation strategies are pursued by owners running a good business.

Appendix – How the Math Works

Revenue Growth

BMTC's revenue in 2009 was $818.1 million, a 51% increase compared to 1999 revenue of $543.1 million. Assuming constant profit margins, constant multiple and no dividends or buybacks, the stock price would be directly correlated to revenue. Therefore, revenue growth during the period is equivalent to the impact of revenue growth on total return.

Margin Expansion

	A	B	C
	1999	2009 – Flat Margins	2009 – Actual Margins
Revenue	543	818	818
Profit Margin	3.4%	3.4%	8.2%
Net Income	18.5	27.8	67.1

The difference between net income in column B and column A is attributable to revenue growth, but the difference between net income in columns B and C is attributable to margin expansion. Assuming constant multiple and no dividends or buybacks, the value created by margin expansion is:

$$\boxed{67.1 \div 27.8 = \mathbf{141\%}}$$

Multiple Expansion

The 1999 earnings multiple was 7.8 times, which increased to 9.6 times in 2009. The difference produced a 23% positive contribution to the 1,300% total return.

At this point, it is important to point out that the components are multiplicative – not additive – which is best explained with a simple example. Imagine a business with \$20 million of revenue and 10% profit margins. Its earnings would be \$2 million. Now, assume that revenue triples and profit margins double to \$60 million and 20%, respectively. Earnings would now be \$12 million, which is 6 times (i.e., 3 × 2) more than the initial number.

Dividends

The total return with dividends was 1,300% and the total return without dividends was 1,130%. Consequently, dividends contributed 14% to the total return:

$$\begin{array}{lr} & \text{Total Return w/o Dividends} \\ \times & \text{Dividend Impact} \\ \hline & \textbf{Total Return w/Dividends} \end{array}$$

$$\boxed{(11.3 + 1)\ (X + 1) = (13.0 + 1) \qquad \mathbf{X = 0.14}}$$

Buybacks

Since we now know the contribution of the other four components of return, we can deduce that the contribution from buybacks was 175%:

$$\begin{array}{lr} & \text{Revenue Impact} \\ & \text{Margin Impact} \\ & \text{Multiple Impact} \\ & \text{Dividend Impact} \\ \times & \text{Buyback Impact} \\ \hline & \textbf{Total Return} \end{array}$$

$$\boxed{(0.51 + 1)\ (1.41 + 1)\ (0.23 + 1)\ (0.14 + 1)\ (X + 1) = (13.0 + 1) \qquad \mathbf{X = 1.75}}$$

Summary

	Return	% of Total Return
Revenue Growth	51%	13%
Margin Expansion	141%	35%
Multiple Expansion	23%	6%
Dividends	14%	3%
Buybacks	175%	43%
Total	**1,300%***	**100%**

*Multiplicative

Author: **John Ewing, Vice President and Director of Research**

October 2010

Great Walls, Wide Moats & Red Flags

The People's Republic of China's rapid development is the envy of the world. The prospect of 1.3 billion people reaching income thresholds that usually portend rising personal consumption levels has many investors, leading economists and business people forecasting a new era of consumer demand and economic growth. Chinese growth may offset the effects of the deep recession on the developed economies. For Burgundy, this would hold out the possibility of great returns from companies that sell to China, and even better, for those that sell their goods in China. Still, reasons for concern exist and all is unlikely to unfold as forecasted. In this *View from Burgundy*, we review China's booming economy and also outline our cautions and concerns.

While most of Burgundy's investments in Asia to date have been made in Japan, we have been very active researching China's economy, looking for ways for our clients to profit from its rise to power and influence. For more than a decade, we have been visiting China and meeting with many foreign and domestic companies doing business there. We have also met with auditors, lawyers, Canadian consular and embassy staff, consultants and business people in an effort to build context around how things work in China, and to better understand the risks and opportunities of investing there.

Red Flags

Our view on China boils down to this: while the pace of economic development and the rise in prosperity in China is dramatic, portfolio investors should proceed with caution. First, economic growth does not automatically mean great investment opportunities. Economic growth in China attracts intense competition and competition erodes corporate profitability. Second, China's underdeveloped legal system provides little protection for companies trying to build competitive advantages. Third, the quality of management and corporate governance in Chinese companies is questionable. And finally, valuations of Chinese companies are unattractive, both absolutely and relative to comparable businesses elsewhere.

Great Growth

The potential of the Chinese market has been the stuff of myth in the West ever since the Industrial Revolution began. In the mid-19th century, a calculation determined that if all Chinese lengthened their garments by one inch, the resulting demand could fill the textile mills in Manchester. For 150 years, such a development was only a myth, but today, with a huge and growing urban population, rapidly rising per capita incomes, massive infrastructure spending and a burgeoning consumer market, the myth is finally a reality and the world is learning to live with the consequences.

According to a recent report published by the McKinsey Global Institute, nearly one billion Chinese could be living in an urban centre by 2025.[89] The migration of hundreds of millions of Chinese from rural communities to urban centres is a fundamental trend that has enabled continuous rapid growth in China's per capita GDP at a rate of about 8% annually for more than 30 years. If the Chinese government's blueprint for development is credible (and so far it has been), we should expect a further tripling of per capita GDP by 2020. In fact, many believe that by 2025 China will have replaced the U.S. as the world's largest economy.

As anyone who has visited China in the last two decades can attest, the scale and pace of development is incredible. The government's massive investment in infrastructure over the years has played a huge part in the country's growth. Investment into railways, airports and roads is staggering and is one of the key factors propelling the economy forward. For example, the Chinese Ministry of Rail program is calling for 18,000 kilometres of new high-speed rail by 2020.[90] To put this into perspective, it took the Japanese 30 years to complete their world-renowned 2,500-kilometre Shinkansen network. The Chinese are building a rail network more than seven times larger in a third of the time! China's Ministry of Transport started construction on 111 expressways in the first half of 2009 and plans to add 60,000 kilometres of new highways over the next few years. This compares to 75,000 kilometres of the entire U.S. Interstate system.[91]

The Chinese market is well on its way to becoming the world's largest market for just about anything you can think of. There are more than 400 million Internet users and almost 800 million cellphones in use in China today. It is the world's largest market for motor vehicles, even though car ownership in China is a fraction of that elsewhere in the world – 40 vehicles per 1,000 people versus 800 vehicles per 1,000 in the U.S. With such a compelling growth story, why is Burgundy cautious about jumping into Chinese investments?

Great Growth Equals Competition and Competition Erodes Profitability

Our first concern addresses a common misconception among investors that economic growth automatically leads to superior investment opportunities.

China's economic growth is undoubtedly impressive, but translating this growth into corporate profitability is anything but assured. Academics have done studies on the correlation between economic growth and stock prices. None yield a definitive positive correlation. In fact, most studies draw the opposite conclusion. For example, a 2005 report by the highly regarded investment firm Brandes Investment Partners & Co. showed that countries with the highest GDP growth posted the worst stock market returns.[92] That study covered 53 countries and included 105 years worth of data.

It may seem counterintuitive, but economic growth is only valuable if a company can translate it into profit and free cash flow growth. Investors make money on companies through high returns on invested capital, not simply through top-line growth that tracks a growing economy.

Finding companies that can grow profitably in China is much harder than one might expect. On our last trip to China, we met with the local senior executives of several multinational companies whose stocks we own: Nokia Corporation, Diageo plc and Shiseido Co., Ltd. All stated that China was simply too large a market for them not to be competing there. The top executive at Shiseido China put it this way: the size of the cosmetics-buying population in China will expand to more than six times the scale of Shiseido's home market (Japan) by 2020. Because of this potential, all of Shiseido's peers (Estée Lauder Inc., L'Oréal Group, Procter & Gamble Co., etc.) are investing heavily in this market. And competition for Shiseido in China is not just coming from these foreign multinationals. Local manufacturers, whose skills and technologies have improved remarkably over the years, are legendary for their ability to introduce look-alike and me-too products.

When you visit Shanghai and Beijing, you soon realize that these markets are the epicentre for competition. Every global company is there and all are fighting for market share. It is vital that we find companies with competitive advantages, which help insulate a business from such intense competition. Only companies with competitive advantages will be able to grow their intrinsic values over time.

Warren Buffett summed it up for us when he said: "The key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather determining the competitive advantage of any given company and, above all, the durability of that advantage. The products and services that have wide, sustainable moats around them are the ones that deliver rewards to investors." [93]

Not-so-great Legal Protections

Finding companies with wide moats is difficult anywhere in the world, particularly in China where competition is fierce, the economy is highly regulated and the legal system is underdeveloped. This brings us to our second concern about China: the Chinese legal system provides little protection to companies trying to build competitive advantages.

Burgundy tends to invest in companies with intangible assets such as unique technologies, licences, brands, patents and trademarks that are hard for competitors to replicate or for customers to find elsewhere. These assets enable a company to differentiate itself and earn higher margins and returns on capital than its competitors. Companies with high-quality, intangible assets are resilient to economic downturns and resistant to competitive pressures over time.

Amusing as examples like “Pizza Huh” and “Adidos” may be, the fact that China’s legal system is still evolving and does not provide basic protection of private ownership rights is a major impediment for companies trying to build a sustainable competitive advantage, and is a major concern for Burgundy. As long-term buy-and-hold investors, we need the assurance that our property is protected by the legal system. The fact that property rights in China are routinely infringed and that the perpetrators go unpunished is worrisome, to say the least.

Not-so-great Governance

Having a competitive advantage may not matter if the companies we invest in have poor management or lack corporate governance. Both issues lead us to proceed with caution when investing in China.

One of the major differentiating factors between the Chinese economy and other developed and developing countries is the extent of direct and indirect government involvement. Three quarters of approximately 1,500 companies listed as domestic stocks in China are former state-owned enterprises that have sold minority stakes in themselves, but remain firmly in the hands of Chinese government entities.

HANG SENG STOCK MARKET INDEX	
Top 10 Companies	**Approx. Government Ownership Stakes (%)**
HSBC Holdings PLC	0
China Mobile Ltd.	75
China Construction Bank Corp.	60
Industrial & Commercial Bank of China	70
CNOOC Ltd.	65
Bank of China Ltd.	70
China Life Insurance Co. Ltd.	70
Petrochina Co. Ltd.	85
Sun Hung Kai Properties Ltd.	0
Tencent Holdings Ltd.	0

Source: Company filings

The chart above lists the 10 largest companies in the Hong Kong Hang Seng Stock Market Index. Seven of them account for about 40% of the index's total market capitalization and are controlled by the Chinese government.

The risk of owning companies controlled by the Chinese government is that the political and social objectives of the government will conflict with the objectives of minority shareholders. Is the China Construction Bank (60% owned by the Chinese government) lending money solely on commercial terms that compensate it for credit risk? Is China Mobile (75% owned by the Chinese government) investing in a new wireless communications network developed and subsidized by the Chinese government purely on expectations of higher profits and returns on equity? We suspect not. While many state-owned enterprises enjoy privileged status within their industries, efficient capital allocation is not the sole priority of government and may not even be deemed important. Management of these companies will also be difficult to assess, since the career paths of many top executives travel through positions in various companies, in the government and in the Chinese Communist Party hierarchy.

Management and corporate governance quality is often an issue even if a company is not controlled or owned by the government. Burgundy likes to invest in companies in which we are reasonably certain the management has a sense of trusteeship and responsibility towards its shareholders. We have yet to find a company in China where self-dealing by management was not a real concern. This is by no means a problem unique to the country, as a glance at the compensation schemes of Wall Street investment banks or indeed almost any Fortune 500 company will prove. Nonetheless, in the absence of avenues of redress, the presence of so many examples of self-dealing is of particular concern to us in China.

To illustrate, look at an example of a common boilerplate disclosure we often find when investigating potential investment ideas in China: "The principal shareholders of our affiliate Chinese entities have potential conflicts of interest with us, which may adversely affect our business."

Many Chinese companies with stock market listings outside mainland China are incorporated in places like the Cayman Islands and, as such, are considered foreign companies under Chinese law. Due to Chinese foreign ownership restrictions, many of these companies are not allowed to own the licences required to operate their businesses. Therefore, the companies enter into contractual agreements with their management (or even friends and family of management) who, as registered Chinese citizens, then hold the business licences on their company's behalf. Such arrangements would normally be a huge red flag for investors; in China, however, they are commonplace and something, we are told, "we'll have to get used to." To which we respond, "what, if anything, do shareholders really own if someone else has the right to operate the business?"

Great Companies Don't Always Make Great Investments

Whether it is intense competition, an underdeveloped legal system and lack of protection for property rights or poor management and governance quality, investing in China offers plenty to worry about. Still, these are not the only impediments Burgundy faces when considering Chinese investments. Finding high-quality companies with sustainable competitive advantages is fundamental to our investment approach, but so too is buying those companies at attractive valuations; and the valuations of excellent Chinese companies that we have found are currently unattractive. The following list includes some Chinese companies we have researched. They are all fast growing, profitable and have dominant market positions in their respective industries. They are a select group of companies that would meet most of Burgundy's quantitative and qualitative criteria:

- Hengan International Group Co., Ltd. is one of China's largest producers of baby diapers
- Tingyi (Cayman Islands) Holding Corporation is one of China's largest snack food and beverage makers
- New Oriental Education & Technology Group helps Chinese students with entrance exam preparation
- Baidu, Inc. is the Chinese equivalent of Google
- Ctrip.com International, Ltd. is a leading Chinese travel service provider for hotel accommodations, airline tickets and package tours

The major issue with owning these companies today is not so much our concern about business quality, but rather our concern about valuations. The average price/earnings ratio of this group is 58 times last year's earnings and 38 times next year's. Great companies don't always make great investments. No company is so good as to be immune from the consequences of overvaluation.

To illustrate, the following table compares these Chinese companies to a group of their international peers:

COMPANIES MUST COMPOUND EARNINGS SIGNIFICANTLY TO MEET THEIR PEERS		
Company	**Trailing Price/ Earnings Multiple**	**Required Earnings Growth Per Year (5 years)**
Hengan International Group Co., Ltd.	**36x**	**17%**
Kao Corp. (Japan)	16x	
Tingyi (Cayman Islands) Holding Corporation	**35x**	**16%**
PepsiCo, Inc. (U.S.)	17x	
New Oriental Education & Technology Group	**50x**	**27%**
MegaStudy Co., Ltd. (Korea)	15x	
Baidu, Inc.	**119x**	**43%**
Google Inc. (U.S.)	20x	
Ctrip.com International, Ltd.	**51x**	**26%**
Expedia, Inc. (U.S.)	16x	

Source: Bloomberg

In this table we have included our estimate of how fast these Chinese companies would have to grow over the next five years in order to bring their price/earnings ratios in line with their international peers. Hengan, for example, trades at 36 times trailing earnings and would have to grow its earnings per share 17% annually for five years to trade at a similar multiple to Kao Corp., which currently trades at 16 times earnings.[94] This assumes that profit margins and taxes stay at today's levels. Tingyi would need to grow its earnings at 16% per year for five years to trade at a similar multiple to PepsiCo, Inc., which currently trades at 17 times earnings. And so on.

Maybe these Chinese companies can continue to dominate their industries, to grow quickly and to maintain their already high profit margins? Maybe they will be able to find ways to protect themselves from the onslaught of competition? If the answer is "maybe not," the consequences would be severe for those who own these stocks at current levels. The quickest way for an investor to lose money is to overpay.

Use Great Caution

While the pace of economic development in China is astounding, portfolio investors should proceed with caution.

China has had an incredible 30-year run of remarkable economic growth. In late July 2010, the Chinese government announced that it had overtaken Japan as the world's second-largest economy, but trees don't grow to the sky and the Chinese government has not repealed the business cycle.

Just as the rulers of the great Chinese dynasties built the Great Wall to protect themselves against intrusions from northern invaders, so too must companies build their virtual walls and defences against the destructive forces of competition currently widespread in China. And like the Great Wall, wide moats take time, money and effort to build. In the meantime, we think we already own several Asian and global multinational companies that have large and established businesses in China and will be able to compete successfully behind wide moats of established brands, financial strength and high-quality human resources. Their valuation discount to their Chinese competitors makes them even more compelling as investments.

There are a number of ways to approach the Chinese opportunity, which is unquestionably the biggest in the world today. There will be fine opportunities to invest directly in Chinese companies for patient investors. An old Chinese proverb says, "dig the well before you are thirsty." While we wait patiently, we will be continuing our search for those companies with great walls or wide moats and avoiding red flags.

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The Most Valuable Option of All

Financial options were designed to help investors maximize upside exposure while limiting the downside. In this V*iew from Burgundy*, we look at how investments that closely resemble financial options can fit into a long-term, value investment approach – especially when they are free. We also find that another definition of option – the right, but not the obligation, to change your mind –may be the most valuable option of all.

A financial "option" is a contract that gives the holder the right, but not the obligation, to transact in a security. Option contracts run for specified time frames, after which they expire. Whether they expire worthless or "in the money" depends on the value of the underlying security. For example, an option to buy a stock at $25 per share is worth a lot ($15) if said stock ends up trading at $40. The same option would expire worthless if the stock was trading for less than $25. Note also that option values can never be negative because option holders are not required to transact. It wouldn't make sense to do so if the underlying security was trading at less than the option price. This means that the option's ultimate value will range from zero to a lot, depending on the underlying stock price.

With options the math can get complicated, but it's enough to know that the downside is limited, and the upside is not. Options sound like a good tool for investors seeking to minimize downside exposure (because options can never have a negative value) and maximize the upside (because their upside potential is unlimited). Unfortunately, financial options have two big drawbacks. First, they cost money. The seller of the option wants to be compensated for the chance that she will have to sell you a share for far less than it is worth. In the above example, the shareholder would have to part with the share at $25, not the $40 that the share would fetch in the market.

The second drawback? Options expire. Investors wanting the benefits of upside exposure with no downside must continually renew their options when the old ones expire and this comes at a price. Unless the upside scenario plays out every time, time will work against you, given the ongoing cash outflows needed to renew option contracts.

There is a better way. What if you could find an investment that looked just like an option – with little downside and lots of upside – and was free? Even better, one where the life of the option was open-ended with no hard expiry date. We would back up the truck and fill our boots. But, does such an investment exist? If so, what does it look like?

Finding Free Options in the Equity Markets

From time to time, Burgundy has found equity investments that seemingly meet these criteria:

- Little downside
- Lots of free upside
- No expiry date

We admit that outside of the old Vancouver Stock Exchange bucket shops, "little downside" and "equity investment" rarely belong together in the same sentence. But we're comfortable stating that the downside is limited as long as a few criteria are met:

- The business model and balance sheet must be low risk
- The company must possess a moat around its economic castle
- Management must be long term and ownership oriented

Warren Buffett calls the companies that meet these criteria "The Inevitables," where earnings, and thus intrinsic values, will inevitably be a lot higher in 10 years than they are today. When these companies are available at a large discount to intrinsic value, then the downside looks less threatening.

We also admit that we are not Warren Buffett. To mitigate this misfortune, we make sure that we own a diversified collection of undervalued Inevitables. While it may be impossible to claim that there is no downside with this approach, history suggests that if your time horizon is long enough, the risk of loss from owning a diversified portfolio of Inevitables, at big discounts to their respective intrinsic values, is very low.

In terms of upside, "normal" earnings growth for Inevitables is typically built into intrinsic value estimates. Conservatism precludes the use of growth rates that differ too much from that of the general economy. Still, intrinsic values should normally grow at regular rates over time. There's a reason that they are called Inevitables. That is also why Buffett, who typically only buys these companies, says that time is the friend of the long-term investor.

But opportunities can be supernormal, and these opportunities are not captured in intrinsic value calculations. A successful new product, geography or investment strategy may offer a way to bootstrap growth well beyond normal rates. Charlie Munger, Buffett's partner, calls any combination of these "lollapalooza" events. When they pay off, shareholders can experience enormous returns. We call these potential supernormal opportunities "options" when their prospective payoff outlook looks much like the prospective payoff of financial options as we defined above – little downside and lots of upside.

Even better, unlike financial options, these "options" do not have expiry dates. While many opportunities are time sensitive, others can persist for a very long time. As we shall see, being exposed to long-term upside can be very valuable.

So we can identify a diversified collection of Inevitables, with limited downside given their low risk business models, balance sheets, management and valuations, several of which possess upside opportunities for shareholders to reap potential lollapalooza returns. In other words, lots of upside. But how can these upside options be free?

The answer: normally, they are not. As the old saying goes, the market is a smart little fellow that typically values companies (and their upside opportunities) fairly appropriately. But from time to time it doesn't. When we are able to invest in an Inevitable at a big discount to its intrinsic value (which includes no value for these upside options), then we are getting the options for free. It doesn't mean we will be any good at predicting which of the options will hit pay dirt. But when we own a collection of them, our experience is that some are bound to pay off handsomely. And you only need a few to magnify overall portfolio returns.

Free Options Can Magnify Equity Returns

Our investment in SNC-Lavalin (see Appendix 1) is a good example of how free options can magnify returns. When we first purchased SNC on September 1, 1999 for C$3.70 per share (adjusted for stock splits), SNC had net cash, no debt and, as Canada's largest engineering services firm, a leading franchise in a good business. Engineering services is a fee business with high margins, little capital required and a variable cost structure that is adaptable to changing business levels. While profits can be lumpy, SNC had managed to report healthy "mid-teen" returns on shareholders' capital in each year of the preceding decade. Management during that time, led by CEO Jacques Lamarre, was conservative and long-term oriented, with substantial personal investment in SNC shares. While project backlog had been falling because of impacts from the 1997–1998 Asian crisis, SNC was trading for less than 10 times earnings – an attractive valuation. We felt that the business decline was cyclical and temporary and that SNC would resume a more "normal" growth rate as economies recovered. As a result, our estimate of intrinsic value for the core engineering franchise was significantly higher than the actual trading price.

So the SNC investment seemed to meet the first "little downside" criteria since the business model, balance sheet, management and valuation were low risk. What, then, were the free options? SNC had a couple, and the first of the two was more obvious to us at the time.

In 1999, just prior to our investment in the shares, SNC purchased 27% of 407 International Inc., which owns a concession to operate Highway 407 in the Greater Toronto Area until the end of the 21st century. The 407 was the world's first open-access toll highway. It seemed to be ideally situated in the growth path of Canada's largest city.

SNC management disclosed their range of assumptions on traffic flow and tolls, which allowed Burgundy to determine that the value of the 407 could potentially be quite material for SNC shareholders. As such, a free potential upside "option" was attached to SNC shares. It was free because we were buying the core engineering franchise at a discount to its intrinsic value alone.

At the time, the second free option was a little more opaque to us. As more than half of SNC's revenue was generated outside of Canada, they were well positioned to benefit from a resumption in global capital spending on mines, aluminum smelters and other projects requiring their engineering expertise. While we had built some "normal" growth rates into our intrinsic value estimation, the option for supernormal growth was attached to SNC shares for free. Little did we know that the world was on the cusp of the biggest capital spending boom in history. We also didn't know that the 407 would turn out to be one of the world's most profitable government concession investments, thanks to annual toll increases that surpassed initial expectations. Fast forward to today and it is plain to see that both options hit pay dirt (see Appendix 2). At a recent price of close to C$60, SNC's shares are up 15 times over our original investment a decade ago, resulting in a compound average annual return of 30% from first purchase.

Even among Inevitables, very few can expect to report "normal" earnings and intrinsic value growth rates of more than 10% per year, sustained over a decade or more. SNC has done far better than that for shareholders, thanks to the supernormal lollapalooza results that stemmed from a couple of "free" options that were available at the time we purchased the shares.

A search for Inevitables with free options is a useful approach to maximize upside exposure while minimizing the downside. Not all holdings will see their respective options hit pay dirt. Nevertheless, it doesn't take many such holdings to magnify returns. For example, if 90% of portfolio holdings average a 10% annual return over a decade, and the other 10% report SNC-like 30% annual returns, the overall portfolio will average 14% per year – a good result.

The Right to Change One's Mind

With the foregoing in mind, is investing a one-decision exercise, where one simply invests in a collection of Inevitables at low valuations with free options, and then sits back and pats oneself on the back for a job well done? No, it is an illusion to think that we know today how to position a portfolio for the next 10 or more years.

If you have locked yourself into a predetermined path, you lack the ability to adapt your thinking and improve your portfolio. An example outside of investing is capital punishment. It is impossible to make use of new evidence or treatment methodologies if the prisoner is dead. So too if your portfolio is locked into a "buy and hold forever" mindset. Investments should be made with conviction, but they should not be irreversible.

Investing should be an ongoing and intensely adaptive process that sets in motion a framing of events whereby the "inevitableness" of the Inevitables is continually questioned – a process that preserves, or even increases, your options as time goes by. In this case, "option" means the right, but not the obligation, to change your mind.

This type of free "option" – the ability to change your mind – may be the most valuable option of all. Things change. Moats fill in. Management can change for the worse. And sometimes company share prices trade above intrinsic value. In these cases, it is invaluable to have the option to get out of an investment to preserve capital.

The option to sell is so valuable because the power of compounding is asymmetrical. Losses hurt our ability to compound capital more than gains of the same size help. A 10% loss requires an 11.2% subsequent gain just to break even. So with losses, pressure builds to generate higher future returns by taking on riskier investments (it is much like falling behind in a golf game, where one is forced to take more difficult shots to try to close the gap). This risk-taking almost always ends in tears. In contrast, a 10% positive return in year one equates to the same dollar gain as a 9.1% gain in year two because you are starting from a higher base. So with gains, lower future returns can still be attractive because they continue moving the compounding machine forward.

You can see from this example that higher returns (which are riskier to chase) are required to rebuild net worth if capital erodes. This is why Buffett says the number one rule in investing is, "don't lose money." In other words, having the option to sell an at-risk investment to preserve capital is invaluable.

It is just as crucial to recognize when company-specific options are paying off, like in the case of SNC, so intrinsic values can be adjusted upward. Selling too soon puts a serious damper on potential returns. If we had sold SNC when it reached our original intrinsic value estimate years ago, and made no allowance as its options were hitting pay dirt, we would have left buckets of potential return on the table.

This is where the open-ended nature of our "option" shows its value. Because there is no expiry date, an investor can remain exposed to an option that is paying off and really coin it.

Let's return to the example of the portfolio where 90% of the holdings averaged 10% compound annual returns and the other 10% reported SNC-like 30% annual returns, leading to an overall portfolio return of 14%. Over a decade, 14% compounded will turn \$1 million into \$3.7 million, while 10% compounds to a lesser \$2.6 million. Clearly, it is important to let your winners ride if their inherent options are hitting pay dirt. This is only possible if your process allows for the flexibility, not just to sell, but to adjust intrinsic values upwards as changes in the underlying economics warrant it.

This does not mean that portfolio activity will be high. Remember, transactions are at the option of the investor. Indeed, a long-term value investor may find that changing his mind happens rarely. Warren Buffett has low portfolio turnover – and produces world-class results. But when warranted, the option to change your mind can add substantial value.

Conclusion

A useful approach to compound capital at superior rates is to employ an ongoing process of searching for a collection of Inevitables with free options – built-in exposures to open-ended upside with little downside. This ongoing, adaptive process preserves an investor's ability to sell if an investment is at risk, or to adjust intrinsic values upwards when warranted. Though always free, this option to change your mind may be the most valuable option of all.

Appendix 1

SNC-Lavalin Group Incorporated (SNC) is the second-largest publicly traded engineering and construction company in North America and is one of the world's largest. SNC also owns a large portfolio of infrastructure investments. Approximately one-half of SNC's C\$6 billion in revenue is generated in Canada, with the balance earned internationally. Many of SNC's 22,000 employees have engineering expertise in mining and metallurgy, infrastructure and environment, chemical and petroleum, power and other industrial projects. SNC was incorporated in 1967 and remains a widely held public company.

Appendix 2

At the time of Burgundy's purchase in 1999, SNC had a market capitalization of C$520 million (with a total of 140 million split-adjusted shares outstanding, multiplied by C$3.70 per share).

Today, SNC's Highway 407 stake alone is worth approximately C$1.5 billion, as confirmed by a recent public transaction (see Exhibit A below). Moreover, after receiving dividends from 407, as well as proceeds from the sale of one-quarter of its 407 stake in 2002, SNC's net investment in 407 is negative C$155 million (i.e., it has taken out C$155 million in cash, net of its original purchase, and still owns a stake worth C$1.5 billion. See Exhibit B below). The 407 "option" alone has created more than three times the market value of the entire company at the time of purchase. Lollapalooza indeed.

In addition, SNC's engineering revenue grew from C$970 million in 1999 to C$4.4 billion in 2009, a compound annual growth rate of 16.4%. The implied market value of SNC's non-407 assets is now C$7.4 billion (a total of 151 million shares currently outstanding, multiplied by C$59 equals C$8.9 billion, less C$1.5 billion for the 407 stake). With the value of SNC's non-407 assets up more than 14 times over the course of the decade (C$7.4 billion today compared to C$520 million in 1999), the global capital spending "option" also hit pay dirt.

Exhibit A

Value of 407 confirmed by recent transaction

SNC's Highway 407 stake is worth approximately C$1.5 billion. This was confirmed in two recent transactions:

- The October 2010, Canada Pension Plan Investment Board purchase of 10% of Highway 407 for C$894 million implied that SNC's 16.77% stake is worth C$1.5 billion.
- In August 2010, the Canada Pension Plan Investment Board acquired Australian toll road operator, Intoll Group, for A$3.4 billion; 90% of Intoll's net asset value consists of its 30% ownership interest in 407. At current foreign exchange rates, this transaction also implies that SNC's 16.77% stake in 407 is worth approximately C$1.5 billion.

Exhibit B

Calculation of net invested capital in 407 International

In 1999, SNC invested C$175 million in the common shares of 407 International. In 2002, SNC sold one-quarter of its stake in 407 for C$178 million, or C$150 million after tax. SNC has also received cumulative dividends of more than C$180 million. Net invested capital (C$175 million, minus C$150 million, minus C$180 million) is therefore negative C$155 million.

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An Investment Lesson from Warren Buffett

People often approach investments without first understanding what they are trying to achieve. Many end up with poor long-term returns and even more confused than when they started. Warren Buffett, on the other hand, has accumulated a $44 billion fortune in one lifetime of investing, starting from scratch, and has never been confused about how he earned it.[95] In this *View from Burgundy*, we will uncover how Buffett frames his investment approach. The investment lesson learned, properly applied, is sure to help us generate improved long-term results.

A Defined Goal and Timeline

How did the Sage of Omaha create a huge fortune from scratch? First, he knew what he was trying to achieve. From a young age, Buffett's goal was to compound capital at the best possible rate over the very long term. So he had a clear and explicit goal: to grow his wealth. He had also defined an appropriate time horizon that was long enough to tackle this problem.

Capital Factors

With the end goal understood, the stage was set for Nebraska's legendary investor to begin his task by constructing an investment portfolio. But where to start? Buffett had two epiphanies that defined his approach to portfolio construction. First, that only ownership could generate the returns he desired, and second, that losses would erode compounding's "magic." Buffett would go on to apply these insights enthusiastically and with extraordinary success for many decades.

The Power of Ownership

The Oracle of Omaha's first epiphany was about the power of ownership and it came at a young age. As a teenager, Buffett purchased some farmland and split the annual crop income with the tenant farmer. After five years, when the land was sold and Buffett doubled his original investment, he learned that although the owner risks the initial capital, only the owner benefits from any capital gains.

Nebraska's legendary investor appreciated that only the investment returns from ownership, or equity, would allow for the opportunity to earn outsized long-term results. He couldn't compound capital at superior long-term rates by investing in debt securities such as bonds and money market instruments. As can be seen by the historical results of each asset class in the following table, stocks on average have compounded at rates close to double those of bonds since 1926. And, Buffett has done a lot better.

Historical Returns (1926 – 2011)

Asset Class	Compound Annual Return
Equities	9.8%
Bonds	5.4%

Source: Morningstar SBBI

Losses Hurt Way More than Gains Help

The second epiphany for Berkshire's chairman was how difficult it is to recuperate capital after a loss. Losses hammer the compounding equation and must be avoided at all costs. The table below shows how much the gain must be, after a given loss, to get back to where you started. For example, if you lose 50% of your money, you need to double it (make 100%) just to get back to square one. That's a tough task.

That's why Buffett codified two rules for investing:

1. Don't lose money.
2. Don't forget rule number one.

The Asymmetry of Negative Returns

Initial Loss of Capital	Subsequent Gain Needed to Get Back to Starting Point	Size of Necessary Gain Compared to Initial Loss
(10%)	11%	111%
(20%)	25%	125%
(30%)	43%	143%
(40%)	68%	168%
(50%)	100%	200%
(60%)	150%	250%
(70%)	233%	333%
(80%)	400%	500%
(90%)	900%	1,000%
(100%)	Impossible	N/A

Note:
Notice how the gap between the two grows as the losses get bigger, captured in the third column. We call it the asymmetry of negative returns. The more you lose, the worse it gets. And, if you ever lose 100%, it's all over.

"No-lose" Equities

These epiphanies helped the Sage uncover perhaps the most challenging investment problem, which many would call a paradox: how does one identify and invest in "no-lose" equities? Indeed, the words "no-lose" and "equities" haven't been used in the same sentence since the seedy days of the Vancouver Stock Exchange.

How did the Oracle solve this paradoxical problem? An examination of his historical investment portfolios uncovers a simple truth that helps reveal the answer. Buffett typically owned very, very few securities (see Appendix 1). Indeed, a big chunk of his fortune has come from a half-dozen huge wins. From the perspective of most people's far too diversified portfolios, the words "very few" hardly do it justice. For example, for most of the 1980s and 1990s, Buffett owned only a handful of stocks, and one of them, GEICO, accounted for up to half of his portfolio. In the early 1950s, GEICO made up three-quarters of his portfolio. That is portfolio concentration.

So Berkshire's chairman articulated his goal (to compound capital at superior rates), set the appropriate long time horizon, and then went about picking very, very few "no-lose" equity investments to build a portfolio. Fast-forward 60 years and he has more than $40 billion. Sounds simple. Clearly Buffett picked the right "very few" investments. How did he do it? Very carefully.

Buffett's Favourite Holding Period is Forever

Buffett uses a mental model to summon an appropriately high level of examination and criticism to ensure that his investment decisions are made carefully. He has often said that an investor should act as though he had a lifetime decision card with just 20 punches on it. This certainly raises the bar for the decision-making process. The Sage has also committed to own many of his companies forever, which gets you to the same place.

This is an important difference from how most market participants go about it. Most own far too many investments, sometimes in the name of diversification and sometimes from being compelled to buy the next "hot" idea or product that the investment industry is touting. Many also jump around among holdings way too much. Indeed, trading activity and fund turnover have increased severalfold over the past few decades.

Many market participants seem to think they can outguess the market with short-term trading. This delusion stems from the misguided notion that one can repeatedly profit from short-term guesses rather than by managing risk. The industry's mediocre long-term returns, together with the tendency of clients to buy at the top and sell at the bottom (so their individual results on average trail far behind that of the funds they invest in),[96] are evidence that this short-termism doesn't work.

Consider an example. We are thesis investors. After we have developed what we consider to be an airtight thesis about a company that includes a guess about its near-term prospects, many times our short-term guess proves to be exactly wrong. This common occurrence, which value investors call "being early," is what gives people fits about the stock market. But as long as the long-term thesis is correct, the investment will perform well.

There is a Big Difference between Uncertainty and Risk

Instead, the Oracle understands the difference between uncertainty and risk, and manages risk accordingly. Beyond the sun coming up tomorrow, everything is uncertain. No one can predict, with certainty, much about the short-term future in the complex, adaptive world we inhabit. So Buffett doesn't even try. On the other hand, risk can be defined and effectively managed, as Buffet's approach and track record highlight. Berkshire's chairman defines risk as the likelihood of a permanent loss of capital. Losses, according to Buffett's rule number one, are to be avoided at all costs since they hammer the compounding equation. Since Buffett wants to own select equities, he must manage equity risk successfully.

Three Sources of Equity Risk

For equity owners, there are three sources of risk of permanent loss: [97]

1. **Business or earnings risk:** where the level of earnings power estimated for a company turns out to be too high.
2. **Balance sheet risk:** where equity owners are dealt losses on part or all of their investment by the investee company's inability to successfully refinance debt maturities as they come due.
3. **Valuation risk:** where one pays too much for an investment.

"Predicting Rain Doesn't Count, Building Arks Does"

To reduce the first source of risk, the Sage very carefully selects only those extremely few businesses where he judges that the long-term business or earnings power risk is as close to zero as possible. As for his appreciation for risk versus uncertainty, consider Buffett's Noah principle: "predicting rain doesn't count, building arks does." While business conditions, like the weather, will always be uncertain, he invests only in those companies that are strong and adaptable enough to thrive no matter what the outside environment throws at them.

While identifying the select few companies is no easy task, the Sage's predilection for a limited number of long-term holdings is a huge advantage when attempting to do so. With far fewer distractions than most over-diversified and fast-trading market participants, Buffett can work hard to identify and genuinely understand those few businesses, the "arks," that will stand the test of time. He places these companies within his circle of competence, which is a boundary inside of which he works to develop genuine and superior understanding. Given his very concentrated portfolios, Buffett's circle of competence may not be wide, but it is deep.

Examples of "arks" include well-managed and dominant consumer brands where the end product doesn't change. The Nebraskan super investor can be sure that these businesses, such as Coke or Wrigley's chewing gum, will still be earning economic rents in 10 or 20 years. He can also be certain that no other transcontinental railway will be built to challenge Burlington Northern Santa Fe and therefore impinge on its high profitability.

As for the second source of risk, that of the balance sheet, the Oracle's insistence on only investing in "arks" provides ample protection. By definition, these types of companies have steady earnings and strong cash flows that help to minimize balance sheet risk.

Patience Can Mean Waiting Decades to Invest

As for the final source of risk, that of valuation, Berkshire's chairman seems to have the patience of Job. Sometimes he has to wait decades before getting a chance to invest in an "ark" he has identified. That is the price one must pay to not overpay for an investment, which can penalize investment returns, or worse, violate Buffett's rule number one and result in an outright loss.

The Black Swan author, Nassim Taleb, has said that, "In science you need to understand the world; in business you need others to misunderstand it." [98] As the essence of value investing is evaluating businesses, the misunderstandings of others about businesses and valuations are where the Sage's opportunities come from. He knows better than most which companies to select, and when they are undervalued and should be bought. This is his primary focus.

And he has the patience to wait. Buffett twice waited 20 years to make investments in insurer GEICO. It takes this kind of patience to accumulate a fortune.

A Study in Patience – GEICO

Buffett's investment history with GEICO is illustrative of his approach.[99] He first discovered the company in 1951 while studying under value investing icon Ben Graham at Columbia Business School in New York City. Noticing that Graham was the chair of something called Government Employees Insurance Company (GEICO), but not knowing anything about it, Buffett took a train to GEICO headquarters in Washington, DC one Saturday morning.

While the office was closed, Finance Vice President Lorimer Davidson happened to be at the office. Hearing from a security guard that one of Ben Graham's students was visiting, Davidson decided to give Buffett five minutes of his time. They ended up chatting for four hours, with Buffett coming out of the meeting with a good understanding of the insurance business and of GEICO's advantaged place in it.

The Sage learned a couple of important lessons that Saturday. First, he learned the value of using "other people's money." Insurance companies collect premiums when they sell a product and don't have to pay out any cash until claims are filed at some time in the future. In the interim period, the insurer can use the premiums as investment funds for their own benefit. This is called "float" and can be a source of free financing or better if the insurance operations are profitable. Buffett has been dining out on this idea ever since.

Second, Nebraska's legendary investor learned that GEICO had a sustainable competitive advantage, or what he called a "moat," around its economic castle. This is extremely rare in the financial services industry where most products are commodities.

By only selling insurance direct, thereby not using and paying hefty commissions to agents, GEICO's selling costs were way below its competitors. By only selling to government employees, who as a group reported far lower than average insurance claims, GEICO's claims costs were also far lower than average. GEICO's lower selling and claims costs allowed it to price its insurance products well below its competitors and still earn healthy returns for shareholders. The low prices made it an easy choice for more and more government worker customers to choose GEICO.

While in 1951 GEICO's share of the national auto insurance market was less than 1%, with its lower costs and prices, it was growing fast. Since government workers made up a big chunk of the potential market, Buffett could safely assume that GEICO would continue growing for several decades. He smelled opportunity (see Appendix 2).

To the Oracle, compounding capital is like rolling a snowball. "The important thing is finding wet snow and a really long hill." [100] GEICO had both in spades. On the Monday morning after Buffett's weekend GEICO visit, he sold three-quarters of his investment portfolio and used all of the proceeds to make GEICO his largest holding by a long shot.

Berkshire's chairman sold his initial GEICO stake in the mid-1950s for a big gain. He had found another quality stock that was way too cheap to ignore. However, Buffett continued to follow GEICO very closely with the hope that he would get a chance to buy it cheap once again. That opportunity presented itself in 1976.

In the early 1970s, GEICO's management team made two errors in the name of "growth at any cost" that eventually hammered the stock. First, they started to accept all comers and sell insurance products to the broad market, rather than just to government employees. Second, they were pricing their products too low, once again in the name of fast growth. These two errors caught up with the company in 1976, when it reported a large loss and fired the senior management team. The stock fell from a prior high of $61 a share to $2. After two decades of watching GEICO from afar, the Sage jumped at the opportunity.

A proven insurance CEO, Jack Byrne, was brought in to refocus the company on its core government employee business. While this corporate turnaround was as challenging as most, Buffett knew that its core business was a jewel hidden inside GEICO. He bought as much stock as he could and soon had spent $47 million to own 48% of the company. This represented about one-quarter of his (by this time much larger) investment portfolio.

With the right management team in place and still a long runway of wet snow to build an even bigger snowball, this time Nebraska's legendary investor didn't sell. In fact, as time went on and his own portfolio grew, he wanted to buy more. Almost 20 years later, in August 1995, Buffett bought the half of GEICO that he didn't own for $2.3 billion. Forty-four years after his discovery and initial investment in this "ark," Buffett finally owned 100% of an advantaged and still growing franchise. This is how fortunes are made.

So what can we learn from the Berkshire chairman's extraordinary success and apply to our own investment process? He identified his investment goal: long-term capital appreciation. With an appropriately long time horizon adopted, he came to realize that this was best achieved by exposing his capital to equities, but not to losses. Although this sounds too paradoxical to be realistic, Buffett has managed to square this circle by successfully understanding and managing equity risk.

The Oracle has succeeded in identifying the very few companies with almost no long-term earnings/business or balance sheet risk. He also has had the patience to wait – sometimes decades – until they were cheap enough to be bereft of valuation risk. Fast-forward 60 years and a $44 billion fortune is the result.

While $44 billion might be out of reach for most of us, simply turning our confusion into clarity is worth a serious examination of Buffett's investment lesson. With a long-term plan, exposure to a limited number of carefully chosen companies and patience, better investment results – and peace of mind – are sure to follow.

Appendix 1

Warren Buffett's holding company, Berkshire Hathaway, had very concentrated equity portfolios. Over the 30 years between 1980 and 2010, the top five shareholdings made up between 58.7% and 93.1% of the total equity portfolio. That is portfolio concentration.

Berkshire Hathaway's Top Five Equity Investments as a Percent of Total Equity Portfolio (1980 – 2010)

(Source: Berkshire Hathaway's annual reports)

1980	
GEICO	19.9%
General Foods	11.3%
Handy & Harman	11.0%
SAFECO	8.5%
Washington Post	8.0%
Top 5 Holdings	**58.7%**

1985	
GEICO	49.7%
Washington Post	17.1%
Capital Cities/ABC	9.1%
Beatrice	9.0%
Affiliated Publications	4.4%
Top 5 Holdings	**89.3%**

1990	
Coca-Cola	38.2%
Capital Cities/ABC	24.2%
GEICO	19.5%
Washington Post	6.0%
Wells Fargo	5.1%
Top 5 Holdings	**93.0%**

1995	
Coca-Cola	33.7%
Gillette	11.4%
Capital Cities/ABC	11.2%
GEICO	10.9%
American Express	9.3%
Top 5 Holdings	**76.5%**

2000	
Coca-Cola	32.4%
American Express	22.1%
Gillette	9.2%
Wells Fargo	8.2%
Washington Post	2.8%
Top 5 Holdings	**74.7%**

2005	
Coca-Cola	17.3%
American Express	16.7%
Wells Fargo	12.8%
P&G/Gillette	12.4%
Moody's	6.3%
Top 5 Holdings	**65.5%**

2010	
Coca-Cola	21.4%
Wells Fargo	18.1%
American Express	10.6%
P&G/Gillette	7.6%
Kraft	5.0%
Top 5 Holdings	**62.7%**

Appendix 2

Growth in GEICO Insurance Policies between 1950 and 2010

When his first investment in GEICO was made in 1951, Warren Buffett felt he had uncovered a company with a lot of growth potential. He was right. Not many companies in history have demonstrated 60 years of annual growth in product unit volumes of more than 7% compounded. Of course, GEICO's value grew at far faster rates, given the ability of management (and later Buffett himself) to invest the ever increasing float.

	1950	2010	Compound Annual Growth Rate
Number of Insurance Policies	143,944	More than 10 million	7.3%

Author: **David Vanderwood, Senior Vice President and Portfolio Manager for Canadian equities**

July 2012

Is Japan Our Future? Investing in Deflationary Times

It has been 14 years since Burgundy began investing in Japanese stocks. While we have generated a reasonably positive rate of return, the experience has been challenging and at times frustrating. Plagued by ballooning government deficits and debt, aging demographics, poor corporate governance and a corporate sector hobbled by increasing global competition and a strong currency, the Japanese economy has stagnated. While many of the Japanese companies we own have done well in this environment – generating high profit margins and returns on capital, producing tremendous free cash flow (most of which is now being distributed to owners through dividends and share buybacks), increasing their market shares and so on – they have not been immune to the sluggish domestic economy or the declining investor interest in Japanese companies.

Japan's economy was a poster child for rapid growth and development in the '60s, '70s and '80s, but over the past 20 years it has managed a mere 1% growth rate in real terms. In contrast to the rest of the world, particularly the developing economies, Japan's poor performance over the last two decades has stood out. During these "lost decades," we have seen the country's economic might and geopolitical relevance diminish dramatically.

Until recently, the long stagnation of the Japanese economy has been regarded as an anomaly and an experience unlikely to be replicated elsewhere in the world. For example, Masaaki Shirakawa, governor of the Bank of Japan, recently told an audience at the London School of Economics, "At various international meetings I have attended in the past 10 years or so, policy-makers and academics often have not seriously discussed the issue of stagnant growth in Japan, simply dismissing it as an idiosyncratic failure of Japan's society and its policy-makers to respond to problems in a swift and bold manner." Indeed, in 14 years of studying Japan and investing in Japanese companies, Burgundy has grown accustomed to hearing economists and investors state that Japan's stagnant growth experience was unnecessarily drawn out and painful due to ill-timed and inadequate Japanese policy responses.

But is Japan's situation really so idiosyncratic? Reflecting on Burgundy's experience investing in this environment, we cannot help but notice Japan is no longer an outlier. The aftermath of the global financial crisis has been characterized by slow growth and high unemployment, as well as an increase in fiscal deficits, government debt loads, political instability and general distrust of capital markets across both the U.S. and Europe – a pattern very familiar to anyone who has followed Japan since the collapse of its credit-fuelled real estate and stock market bubbles in the late '80s. With this in mind, we believe investors may benefit from the lessons we have learned investing in Japan over the last 14 years. Specifically, in uncertain times, investors should stick to quality companies and remain patient and disciplined.

Turning Japanese

The Economist drew attention to the economic similarities among the U.S., Europe and Japan with its July 2011 cover showing President Obama and German Chancellor Merkel dressed in kimonos under the headline, "Turning Japanese." George Soros, one of the most successful investors of all time, whose views on investing and economic issues are widely followed, recently stated in Newsweek, "The situation is about as serious and difficult as I've experienced in my career. We are facing an extremely difficult time, comparable in many ways to the 1930s, the Great Depression. We are facing now a general retrenchment in the developed world, which threatens to put us in a decade of more stagnation, or worse. The best-case scenario is a deflationary environment. The worst-case scenario is a collapse of the financial system."

Burgundy is not a macro investor and eschews making any top-down macroeconomic forecasts. While we don't ignore the macro economy, we would rather focus our efforts on bottom-up, company-by-company research than top-down macroeconomic analysis. As Warren Buffett has said, "Investors should price, rather than time, purchases. It is folly to forgo buying shares in an outstanding business whose long-term future is predictable because of short-term worries about an economy or a stock market that we know to be unpredictable. Why scrap an informed decision because of an uninformed guess?" Yet, as investors in companies, we are acutely aware that the macroeconomic environment has a direct influence on the companies we own. Deflation is rare and particularly tough on business. The increasing prospect of an emerging harsh global economic and business climate warrants a closer look at any relevant experience. And, Japan's experience over the past 20 years may be disturbingly relevant to today's issues.

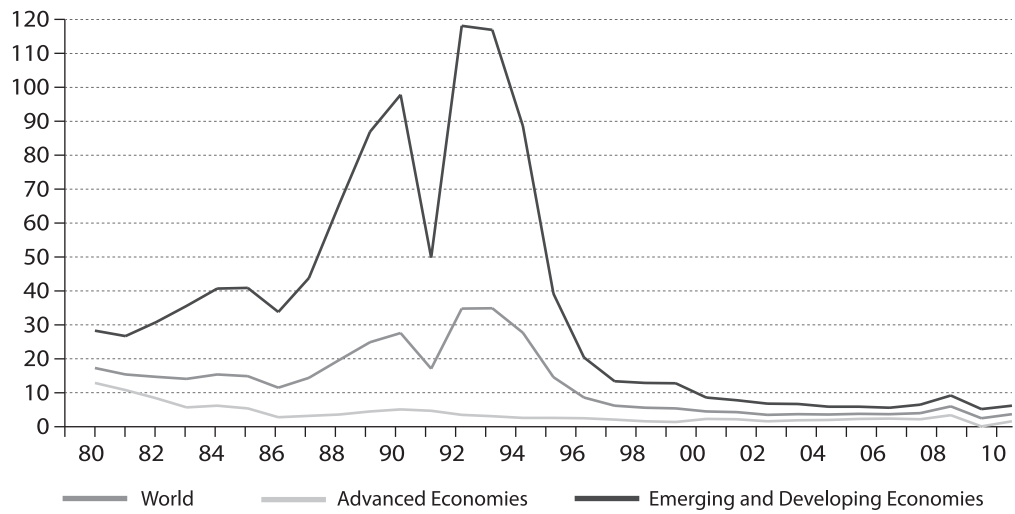
The Dangers of Deflation

Over the past 75 years, there have been only three significant episodes of deflation in the U.S., with the last taking place in 1949. The world has had a similar experience. Over the past 40 years, for example, the world consumer price index (as shown in Figure 1) has seen inflation (in some countries even hyperinflation) and a significant period of disinflation, but no deflation. Remarkably, Japan has had quite the opposite experience. In contrast to the world's experience, Japan has been in deflation for most of the last two decades (see Figure 2)!

Figure 1

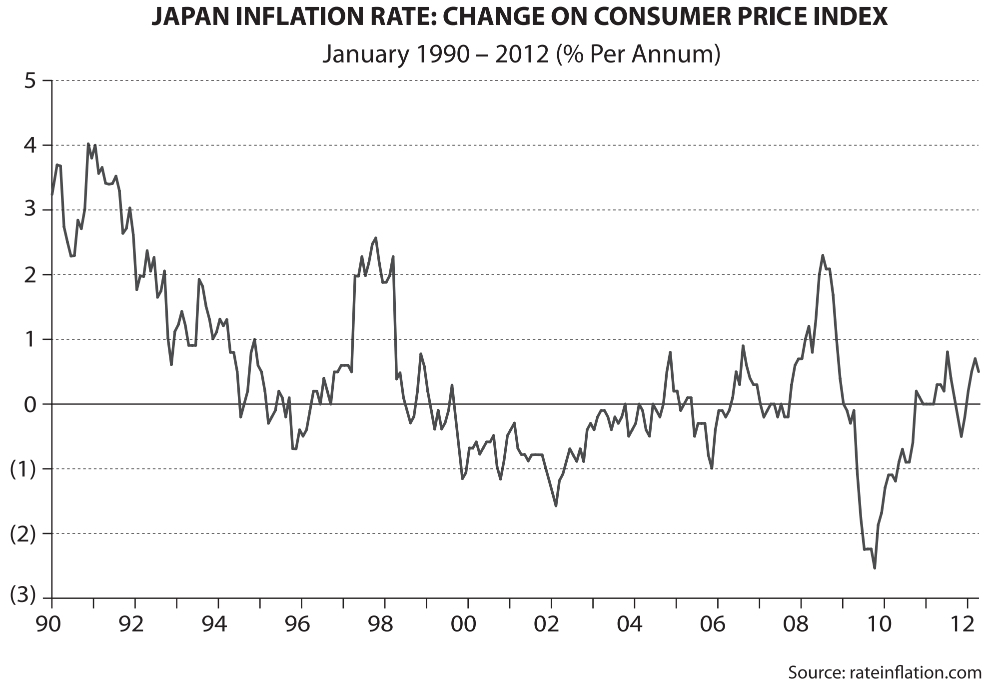
WORLD CONSUMER PRICE INFLATION

1980 – 2010 (% Per Annum)



Source: Dr. Peter Warburton, "Practical History of Financial Markets" course at the Edinburgh Business School

Figure 2



Deflation hurts an economy in a number of ways:

- **Steadily falling prices of goods and services wreak havoc on businesses.** Given that labour costs are sticky, profits fall as prices fall. Eventually, businesses respond to falling profits by cutting labour costs, causing unemployment to rise. As unemployment rates rise, wages tend to fall. As wages fall, demand for goods and services suffers, putting further pressure on prices and on businesses. A downward spiral develops.
- **Persistently falling prices give rise to the paradox of thrift.** When consumers expect prices to fall, they delay or forgo many purchases. If everyone simultaneously attempts to save rather than spend, total savings in the population decline because of the decrease in overall consumption and economic growth. Central bankers prefer inflation to deflation, some saying they will do whatever it takes to prevent this demand-deficit situation from arising.
- **Sales growth in a deflationary environment is very difficult to achieve.** In deflation, businesses cannot rely on the organic growth drivers of steadily rising prices and volume. In absence of mergers and acquisitions,

a world of deflation forces companies to scale down to reduce costs. Paradoxically, a smaller-sized business struggles to compete in a world where low cost and low prices are the critical factors of success.

- **Deflation coincides with dramatic declines in real estate and stock market prices, resulting in widespread destruction of wealth.** Deflation causes the real value of debt to rise. Therefore, using debt to help fund purchases of homes and stocks (which is very common in normal inflationary periods) becomes toxic in deflationary periods and leads to a quickening of the wealth-destruction process. Falling house prices, for example, lead to higher loan-to-value ratios for homeowners. If price declines are severe enough, home equity can disappear, leading to mortgage defaults and forced selling. Widespread consumer deleveraging is common in deflation and is very destabilizing for markets, as well as the overall economy. It is a fertile environment for what Nassim Nicholas Taleb calls "Black Swan" events.
- **Deflation robs an economy of dynamism because it favours savers over borrowers and the elderly over the young.** Poor investment performance and extreme volatility in risky asset prices eventually dampen the "animal spirits." Outside of government bonds, there is nowhere for investors to hide and eventually people begin to prefer cash and cash equivalents over any other investment alternative.
- **For governments and policy-makers, deflation makes traditional monetary policy ineffective.** With fewer levers to pull, governments must rely on fiscal stimulus to help the economy. There are, however, political and economic limits to government spending. Furthermore, common policy responses to problems caused by deflation (such as financial system instability, high unemployment, rising social instability, etc.) usually have long-term negative consequences that impede economic growth. For example, low interest rates help companies avoid failure, but they slow down restructuring. Government bailouts secure employment but impede industry realignment and rationalization. Increasing government fiscal deficits help stabilize the economy but lead to a crowding out of private-sector investment.

Deflation and Business

Given how tough deflation is on the economy, it is not surprising that very few companies (at least as far as their stock prices are concerned) do well in such an environment. Figure 3 shows stock price performance of the Tokyo Stock Exchange's 33 industry sectors since 1998, when deflation first took hold in Japan.* The Japanese stock market average is down approximately 40% since 1998 and many sectors of the market are down even more!

While on the surface it appears the average investor does very poorly investing in a deflationary environment, we caution against drawing any firm conclusions. The aggregate stock price performance masks a tremendous disparity of performance among companies in each industry. For example, while the technology hardware and equipment industry suffered an average stock price decline of 43% since 1998, Canon Inc. (a constituent of that group) saw its stock price increase! Based on our experience, and supported by a closer look at the data, stock price and company performance are linked to factors other than deflation. Such factors include high initial stock prices (i.e., valuation), industry regulatory changes, globalization and competition. The bottom line is that, while investing in a deflationary environment is challenging, not all companies (and investors) suffer a similar fate.

FIGURE 3

STOCK PRICE PERFORMANCE OF JAPAN'S INDUSTRY SECTORS 1998 – 2011

Industry Classification Benchmark Sector	Performance	# of Firms
Alternative Energy	245%	1
Mining	167%	2
Tobacco	161%	1
Oil Equipment, Services & Distribution	67%	1
Pharmaceuticals & Biotechnology	64%	39
Mobile Telecommunications	28%	5
Automobiles & Parts	21%	125
Industrial Metals & Mining	21%	70
Industrial Transportation	5%	70
Chemicals	4%	158
Health-care Equipment & Services	2%	32
Industrial Engineering	(3%)	247
Support Services	(4%)	84

STOCK PRICE PERFORMANCE OF JAPAN'S INDUSTRY SECTORS 1998 – 2011 (cont'd)

Industry Classification Benchmark Sector	Performance	# of Firms
Aerospace & Defence	(5%)	4
Gas, Water & Multi Utilities	(6%)	17
Food & Drug Retailers	(6%)	53
Food Producers	(6%)	121
General Industrials	(10%)	36
Oil & Gas Producers	(12%)	9
Electronic & Electrical Equipment	(18%)	189
Personal Goods	(18%)	92
Travel & Leisure	(19%)	94
Household Goods & Home Construction	(22%)	69
Leisure Goods	(25%)	29
Forestry & Paper	(28%)	12
General Retailers	(28%)	142
Software & Computer Services	(29%)	51
Real Estate Investment & Services	(31%)	36
Media	(32%)	28
Construction & Materials	(32%)	247
Beverages	(35%)	14
Technology Hardware & Equipment	(43%)	90
Electricity	(46%)	10
Banks	(50%)	73
Fixed Line Telecommunications	(55%)	1
Financial Services	(56%)	41
		2,293

* **Note:** we are not using stock price performance dating back to 1990, when Japan's housing and stock market bubbles burst, because the consumer price index was still positive.

Lessons Learned Over the Years

Burgundy's experience investing in Japan's deflationary environment over the last 14 years has taught us a few things. Here are some of the insights we have acquired and lessons we have learned.

- **A deflationary environment is the opposite of a "rising tide lifts all boats" environment.** More than in any other environment (inflationary, disinflationary and hyperinflationary), the quality of businesses and their management matters. Companies with enduring competitive advantages and strong balance sheets, generating high margins, returns on capital and generous amounts of free cash flow, do well during deflation (largely at the expense of weaker competitors). Investors in these companies have profoundly different experiences in deflationary periods than the average indexed investor.
- **Investors should look for companies that can consistently differentiate their products or services (brands, quality and pricing) from their peers.** Pricing power is rare in a deflationary environment; therefore, ordinary companies will find it difficult to grow. Investors should look for companies that excel at new product development and that can find ways to grow market share without sacrificing margins or profits. Also, look for businesses with sufficient geographical diversity to offset weak domestic demand. Organic growth in a deflationary environment will not be accidental.
- **Low cost disruptors do well in deflation as market-share growth offsets falling prices.** Disruptors, or companies that make a competing product at a much lower cost, actively use low price as their main strategy. Incumbent competitors who do not want to sacrifice profits are often reluctant to compete with disruptors on similar terms. The loss of market share (i.e., volume) and severely declining prices (brought about by the disruptor strategy) create an extremely challenging environment for all but the new competitor. With an absence of growth, investors should focus on companies that are cost competitive.
- **Companies with debt perform poorly relative to those without debt.** Deflation causes the real value of assets to fall and the real value of debt to rise. A company's balance sheet comes to matter as "good credits" (companies with strong balance sheets and fundamentals) are able to borrow easily and cheaply while "bad credits" (companies with poor balance sheets and fundamentals) are starved of capital.

- **Banks and financials perform very poorly.** Banks suffer from a lack of demand for loan growth, net interest margin ("spread") compression due to intense competition, and a constant pressure to increase provisions as deflation eats away at asset values and the collateral values against those assets. Provisions and writeoffs eventually erode a bank's equity (and the banking industry's equity), giving rise to insolvency concerns. Industry insolvency concerns lead to credit rating downgrades, rising borrowing costs and forced asset sales. This should sound familiar to anyone following the European banking industry today.
- **Capital-intensive and commodity businesses suffer greatly in a deflationary environment.** Volume growth is critical for these businesses, but hard to come by in deflation. Usually when volumes fall for a capital-intensive business, so do its margins and cash flows. Falling cash flows lead to rising debts. Remember, the use of debt and leverage during deflation is a toxic formula.
- **Traditional Ben Graham statistical valuation methods do not work well.** Seth Klarman, founder and president of Baupost Group, a very successful and widely admired investment partnership, explained in his famous book on value investing, *Margin of Safety*, "In a deflationary environment, assets tend to decline in value. Buying a dollar's worth of assets for 50 cents may not be a bargain if the asset value is dropping. The possibility of sustained decreases in business value is a dagger at the heart of value investing (and is not a barrel of laughs for other investing approaches either). Value investors place great faith in the principle of assessing value and then buying at a discount. If value is subject to considerable erosion, then how large a discount is sufficient? Should investors worry about the possibility that business value may decline? Absolutely."
- **Deflationary periods are characterized by rising concerns of systemic risks and extreme levels of uncertainty; corporate management and investors will require patience and discipline to have success.** However, this is easier said than done. Very few management teams or investors have experience operating or investing during an extended period of harsh economic climate, causing them to underestimate the challenges and changes that take place.

Quality, Patience, Discipline

Will the developed world suffer a similar fate to that of Japan? Will the U.S. and European economies experience a long period of stagnant growth and deflation or, as George Soros has warned, far worse? While there are many views on the subject, no one knows!

Deflationary environments are characterized by uncertainty and volatility. This is especially true when deflation results from the bursting of a credit-fuelled bubble, as was the case in Japan. Richard Koo, author of *The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession*, would say that one should not underestimate the extent of damage caused by a balance sheet recession (another way of saying deflation) and the time required to deal with it. The larger the bubble, the longer it will take to mend. Too many people today believe that swift and bold government and central bank policy can get the world out of any mess. Based on Burgundy's investing experience in Japan, we are skeptical of this view.

However, while most investors are fleeing the stock market to seek safety in government bonds, we remain upbeat on the prospects for our portfolios. At the end of the day, our experience in Japan has taught us that investors can make money in the most uncertain times by focusing on quality companies and remaining patient and disciplined.

Author: **Craig Pho, Senior Vice President and Portfolio Manager for Asian equities**

October 2012

Surviving Success: Investment Management and Value Added

Richard Rooney, President and CIO of Burgundy Asset Management Ltd., delivered the following presentation in Halifax at the International Foundation of Employee Benefit Plans (IFEBP) Canadian Investment Institute Conference on August 13, 2012.

The job we do as trustees is one of the hardest I can think of. I say we, because I have served as trustee on several pension and endowment funds. Successful committees have to know something about the capital markets (at least enough to be afraid of them); they have to be able to assess investment managers, which is an art in itself; and they have to have good internal dynamics, balancing diversity of backgrounds and opinions with the ability to work together harmoniously and support the group's decisions. I have served on about six of these committees, and most of them fell short in at least one of these areas. But that is a topic for another day.

Let's focus on money management. I've spent almost 28 years in the business (for the consultants in the crowd that's 111 quarters). I have worked in the investment department of a big financial institution (Sun Life Financial), at an index-oriented investment counsellor (AMI Partners), and for almost 18 years I have been at Burgundy Asset Management, where we pretty well started from scratch. About a third of Burgundy's business is pension funds. We manage a number of different mandates for pension clients, including Canadian equity, balanced, EAFE/international, U.S. and Canadian small-cap, and global mandates in Canada, the U.S. and the U.K.

Identifying the Enemies of Value Added

First of all, let's define our terms. My definition of value added is:

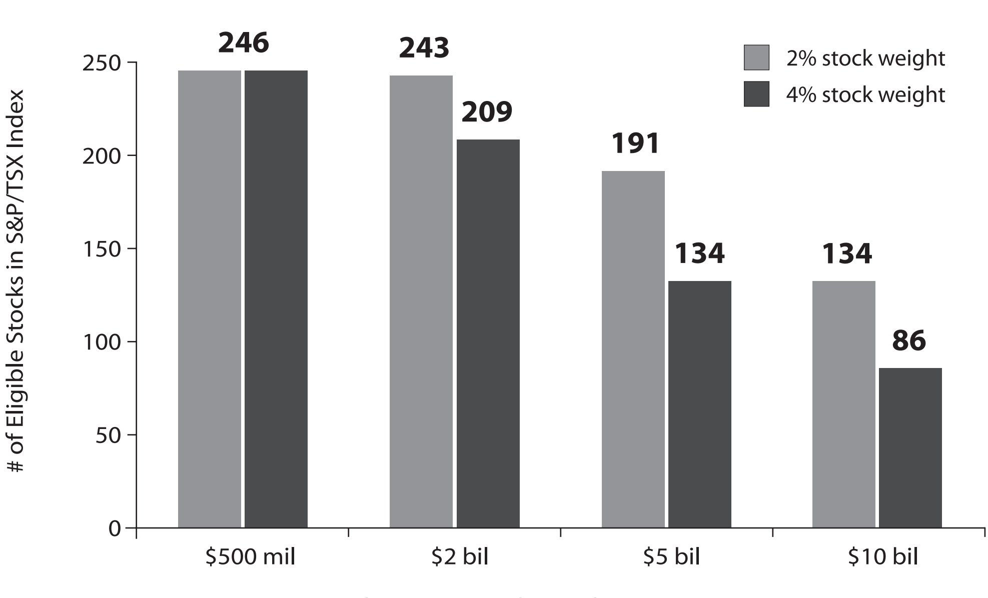
> "Making more money than an available low-cost indexing strategy, over a reasonable time frame, after all costs including management fees."

Enemies of value added for investment managers include size, benchmark orientation and lack of downside protection, among others. We'll deal with all those issues at length, but in my opinion, they are only symptoms of a much more dangerous disease and one that very few investment managers survive: their own success. I hope to show you that by their very success as businesses, money managers usually plant the seeds for future shortcomings as investors. This occurs even though, ultimately, it is as investors that you are going to judge them. I hope to be able to give you some pointers on how to spot a manager who is on his way to negative value added.

Enemy #1: Size

Let's start with the negative relationship between size and the ability to add value. This one doesn't apply to all asset classes. In some cases, being bigger can mean being better, because there are economies of scale, as there are perhaps in the bond business. In a lot of really large markets, such as U.S. equities, you have to get really huge before the problems of size start to arise. But there is one vital asset class where attracting a lot of assets can mean the end of value added for clients: Canadian equities. Let me show you a simple exercise to illustrate the point.

SMALLER INVESTABLE UNIVERSE AS MANAGERS GET TOO BIG



# of eligible stocks based on 10% max. ownership, as restricted by most investment policies

Let's say you have four Canadian equity managers. They operate under these strict rules: first, they can't own more than 10% of the stock of any company they invest in; second, they must own equally weighted portfolios of 50 stocks (2%) or 25 stocks (4%).

The manager with $500 million under management can own anything he wants from the 246 stocks in the S&P/TSX composite index under these rules. But for the managers with $2 billion and $5 billion, things start to get more restrictive. The manager with $5 billion has a lot of stocks he cannot own – 55 stocks in his 50-stock portfolio and 112 stocks in his 25-stock portfolio, to be exact. And, Mr. $10 Billion is really in trouble – he has access to only about half of the stocks in the index if he owns 50 names, and a third of them if he owns 25. We can be sure that for any companies toward the lower end of the capitalization range, he will be butting up against that 10% ownership barrier.

The largest manager will have to own the largest companies available because those are the only ones he can get enough of. If he tries to own smaller companies he will end up owning a high percentage of their stock, and if anything goes wrong, he will not be able to exit his position. If things go really wrong, he will have to ride it all the way down. The $500-million manager, by contrast, will not amount to a very high percentage of the ownership or trading of any position he owns, and can enter and exit positions much more quickly and cleanly.

Investment managers usually make their reputations when they have fairly limited assets under management and lots of flexibility. Great returns are usually the result of buying something that is overlooked and undervalued in the market – and that is usually not the big, heavily traded, highly researched companies that the biggest manager has to own. Most investment managers will produce great returns from small- and mid-cap investing and as they grow they will migrate their funds to large caps. So if you are a really smart client and hire the $500-million manager, and he goes on a multi-year tear raising assets, you might find yourself after seven or eight years with the $10-billion manager after all.

The only way a manager can stop this process of limiting his own opportunities through growth is to close funds. You can see that if you close your fund, say, at the $2-billion level, you preserve a lot of flexibility for your clients even if you have concentrated portfolios. You would be using the best rule of thumb I can think of for closing funds – when your next client is not going to get the same product as your first client in your product.

Closing funds is very painful and difficult. You are usually doing it just when you are starting to get traction in the market and consultants are finally up to speed on your product. If you do it too suddenly and before you have another product ready, you can really tick off a lot of people. I speak from experience here.

The important thing, though, is truth in advertising. If at the end of 10 years our $10-billion manager is showing Canadian equity numbers that were largely generated when he was managing much smaller amounts of money, then that is misleading. He will not be able to replicate those returns. It is far better to launch a new product where you openly proclaim that you will be selecting stocks from the smaller universe of large-cap companies. That way, everybody knows where you stand. You can still add value in the replacement product, just not as much as in the original. And, of course, at some point you will have to close the replacement product too.

What I am talking about here really is the difference between being an asset gatherer and an asset manager. The asset gatherer is just interested in getting big with the attendant profitability that brings. And, make no mistake, investment management is probably the most profitable legal business in the world. Every new client has an almost 100% profit margin. That is why most investment managers are run for the next client in the door rather than the ones they already have. That is why it's so difficult to shake the growth habit once you're hooked. Every new client helps make you rich, and remember: "Who wants to be a millionaire?" is a rhetorical question on Bay Street.

We'll return to this point from a different angle later, but let's continue on to the second enemy of value added we identified: index or benchmark orientation.

Enemy #2: Benchmark Orientation (Closet Indexing)

We are all benchmark-oriented to some extent in this business. The first thing you probably look at in the quarterly report is how the manager did against his benchmark, though something tells me more and more of you are also looking to see if he made any money. There is nothing wrong with having a benchmark; it gives you some idea of how the manager is doing against the investments available to him.

The problems arise when the manager looks too much like the benchmark. And, the bigger he is in Canadian equities, the more his portfolios are going to resemble the benchmark. This is called closet indexing and it just means looking as much like the index as you can while pretending to manage money. It's really the weights in the index calling the shots, not the investment manager.

How can you tell if your manager is closet indexing? Ask him to provide you with his active share.

Active share is a simple calculation that tells you how much the manager has in common with the index. Academic literature shows that managers with high active share add more value than managers with low active share. An active share of:

- 0 would be a perfect index fund
- 50 – 70 means the manager has reasonably large differences from the index
- 70 – 90 is very high and means the manager is actively exploiting opportunities that the index weights do not reflect
- 100 means the manager owns nothing in common with the index

You don't want to pay much for closet indexing. If you are paying more than an index fee for a manager who will literally be unable to add value, you are getting ripped off. But it's not just a matter of paying too much for something that is available cheaper. Blindly following the index is a dangerous strategy that can cost you a lot of money.

Capitalization-weighted indexes such as the S&P/TSX weight stocks according to the number of shares multiplied by the current price. The higher the price of a stock, the greater its weight in the index will be. In normal times, that shouldn't be a problem, but sometimes the market gets itself into a bubble – either on a sector or an individual stock – and things can get very dicey. If you look back over the past few years in the market, owning things just because they were big was a very dangerous strategy. Here are some of the more prominent torpedoes:

- **Nortel:** from $398 billion (2000 peak) to bankruptcy in 2007
- **Research In Motion (RIM):** from $60 billion (2008 peak) to less than $5 billion in four years
- **Sino-Forest:** from $6 billion (2011 peak) to bankruptcy
- **Bre-X:** from $6 billion (1996 peak) to bankruptcy

Investment managers shouldn't own things because they are in the benchmark; they should own them because they have researched them thoroughly and believe the investments will give good returns to clients. A couple of these big index weights were outright scams; any manager who owned Bre-X and Sino-Forest has a lot of explaining to do.

The Canadian market is also troubling as a benchmark because it has become so narrow and shallow. When I started in the business, we had four public Canadian breweries, three distillers, two tobacco companies, five steel companies and the world's largest mining companies (Inco, Alcan, Falconbridge and Noranda). They're all gone, taken over by foreign companies. What's left is not terribly appetizing, to be honest.

Three industry groups account for more than three-quarters of the index – energy, materials and financial services. It's an undiversified bet on a certain kind of global growth story. So you have another reason not to want a closet indexer as a manager – they are imitating a pretty poor benchmark.

Enemy #3: Lack of Downside Protection

It may seem odd, but investment managers, especially those who closet index, just forget that losing money is a bad thing, period.

Here is a table that illustrates how destructive losses are:

THE IMPORTANCE OF MANAGING DOWNSIDE RISK

Initial Loss of Capital	Gain Needed to Get Back to Starting Point	Size of Necessary Gain Compared to Initial Loss
(10%)	11%	111%
(20%)	25%	125%
(30%)	43%	143%
(40%)	68%	168%
(50%)	100%	200%
(60%)	150%	250%
(70%)	233%	333%
(80%)	400%	500%
(90%)	900%	1,000%
(100%)	Impossible	N/A

If you lose 20% of your money, you need to make 25% to get back to even. If you lose 50% of your money, you need to double your money to get even. If you lose 75% of your money, you have to quadruple your money just to get back to your starting point. This is just math, but it shows how tough the investment job becomes if you have large drops in asset values. That is why 2008 was such a watershed – investors are all still trying to recover from the losses of that year.

There is a field of study called behavioural finance. It studies the reactions of real people to financial outcomes. The conclusions of those studies are consistent – people always find losses to be about three times as painful as they find gains to be pleasurable. Those of you who have served for a long time on investment committees will probably confirm this – when you see a 20% gain you feel pretty good, but when you see a 20% loss you feel like you've been kicked in the head. It's not just you – it seems to be how we're hard-wired psychologically.

You'd think that investment managers, who are usually good at math and who generally know about these behavioural issues, would therefore spend a lot of time thinking about the downside of their investments. But that is not the case. They are often so focused on the benchmark that beating it becomes their only concern. Who here hasn't been frustrated when a manager comes in for a review and looks as pleased as punch that he is only down 10.5% when the market is down 11%? From a trustee's perspective he's thinking the wrong way – but as far as he's concerned he's lost just enough money not to get fired.

I mentioned that I felt all of these enemies of value added were really just symptoms of a more serious disease – success. I wonder how many of you have ever seriously thought about what is going on in the organizations that manage your money.

At its base, the problem is that there are two kinds of success an investment manager can achieve. One is investment success, which involves producing competitive returns for clients over long periods of time, and adding value to client benchmarks. That is what I call professional success. If it is achieved, it is very good for the client as well as the investment manager. The other kind of success is business success. Business success involves maintaining and growing assets under management, and generating profits for the owners. These two kinds of success, professional and business, are always in competition with each other in an investment management firm. As these firms grow and prosper, almost always as a result of their professional success, business concerns and issues come to predominate and ultimately take over the firm. The waning of professional concerns, the reduction of investment focus and its replacement by focus on appearances rather than substance and results are what kills investment managers.

Let me illustrate.

The Investment Manager Life Cycle

I would like to quickly run through the life cycle of a money management firm from birth to death and the challenges that arise at each stage. It is quite predictable and leads to the same pathologies over and over again. I hope to show you how a perfectly logical and sensible series of responses to the issues of growth and management of the business will almost inevitably lead to a situation where the manager is unable to add value and may actually be endangering the financial health of his clients.

Birth

A new investment management firm is usually started by one or two investment people who leave a large organization to set up shop. They are convinced that if they can just escape the constraints of the large organization, they will be able to perform well and attract clients. They will start with a determination to focus completely on investments, and probably with a desire to keep it simple, offering one or two focused products. In Canada, usually that product will be Canadian equities. What are the characteristics of this new firm?

They have one objective: survival. And, they have only one means of survival: producing good returns. A startup firm has an energy and focus about it that makes being there an unforgettable experience. You are in a race against time – you have to produce a good enough track record to attract clients, and do it before you go bankrupt because you have probably invested your life's savings in the firm. There are no distractions from the goal of producing returns. As you can imagine, at this level, client interests and investment manager interests are perfectly aligned. Clients who have the guts to hire you are rewarded with total investment focus and personal service too. I still make a point of servicing Burgundy's early clients, because you "dance with who brung you."

So am I recommending that you all go out and hire startup investment managers to run your pension funds? Of course not. These managers will have a high rate of failure because not everyone is able to manage money for competitive returns. It really all depends on the people involved – if they are experienced and disciplined, they will survive and prosper and so will their clients. So if you see someone with a significant amount of experience (say 7 – 10 years) leaving a big organization to set up his own shop, you might consider giving them a meeting, if only to contrast them with your current manager.

Thriving Childhood

Let's assume our new firm beats the odds and produces numbers that start to attract a client base and early adopter consultants. This can happen pretty fast – in my firm's case it took about three or four years (though it didn't feel that fast at the time). If you stay in style for a couple of years, you will start to attract a lot of clients. The young firm will start to hire client-facing people to handle the relationships. The firm will start to hire administrative people to handle compliance, contract and transaction matters. The firm will have to hire more and more managers to manage the people in these various departments. If the investment people are trying to manage the firm, as they often do in this early stage, they will find it more and more distracting and difficult to deal with the people issues. Remember, investment people are usually analytic personalities. They love numbers and concepts. They don't tend to be crazy about people, and that can make them very poor people managers.

You can see even at this early stage how the demands of the business are starting to encroach on the demands of the profession. New clients mean more revenue, but also more complexity, and you have to build headcount to deal with the complexity.

Troubled Adolescence

And then, inevitably, the firm experiences its first setback. Performance falls off, at least partly because the investment people are now doing something they are ill-prepared for, which is managing people. Usually it will also have to do with the firm's style falling out of favour. Tensions between the management of the business and management of the portfolios become acute at this stage.

Lots of firms fall apart here, with departures, layoffs and loss of professional reputation. In some cases, the managers may sell their business to a big financial institution and just exit. Let's assume the firm holds together and decides to reinvest and reorganize. A review of their business will show that they are far too dependent on one asset class (usually Canadian equities). So they will begin to build or acquire expertise in other asset classes, perhaps fixed income or foreign equities. They will bring in high-powered management talent to ensure that the firm's people are mobilized correctly. What they will probably not do is close their main fund, although this would be a good time to do that.

Prime of Life

If the reorganization works, the company comes into its own. New investment people are hired and assets can build to a very great extent. There will be a renewed sense of permanence about the firm, and they will become a safe bet for pension investors. Presentations will be slick, relations with consultants and clients will generally be cordial, and resources to support those relationships will be plentiful and effective. This period can last for decades and business success will be tremendous. The firm can continue to add value, though its contribution will be falling gradually over time as assets grow. And then, at some point, a fresh set of problems will arise.

The Long Goodbye

I call the last period the long goodbye. The founders of the firm have to start thinking about an exit strategy. The investment managers who have generated the good returns are aging, and increasingly at risk of health problems, disability, divorce or any of the other things that can alter the course of a life. The next generation of investors may not be given the opportunity for the same degree of risk-taking and initiative that the originals were given. And, of course, that is because they have a very large business to protect.

At this stage, business concerns are paramount. People are less concerned with excellence on the investment side. They simply want to do well enough not to get fired. That old chestnut about being first quartile in the long term if you can just stay above the median for a few years will start to be used. Who ever heard of excellence through mediocrity in any other walk of life?

Due to the (in some ways quite justifiable) obsession of consultants with investment manager turnover, there will be a tendency to pretend that investment management is now being done by groups or committees so the original managers can sneak out the back door without scaring too many people. They will misleadingly call these groups "teams." Sometimes you will see groups of 20 or 30 people that are allegedly managing the funds. Now, I have dealt with investment people my whole life and I can tell you that if you give them a place to hide, they will hide. And, in a group that big, everybody is hiding. Nobody takes responsibility, everybody is risk averse, and ultimately everybody looks to the benchmarks for their lead in managing the portfolios. How overweighted or underweighted you are becomes the test, rather than the characteristics of the company as an investment. You will get negative selection as the investment people who want to make a difference get frustrated and leave to form their own firms, and the timid and bureaucratically adept will stay.

The most dangerous thing about this situation is that the manager is systematically depleting the very thing that is most vital to his clients' long-term financial health: the ability to assess investment risk. A committee member who owns something because it is a large part of the index is not assessing the risk of the investment – he is protecting his business from the risk of being different from the index. And, ultimately that decision to hold Nortel or Sino-Forest will lead to severe underperformance. And, the manager by that time will no longer possess the skills to make up those losses to the clients.

This is the portrait of an investment manager at the end of its rope. If you looked at the income statement, you would say it is a phenomenally successful business. But then look further.

Characteristics of a Messed-up Manager

The company probably has a huge portfolio of Canadian equities that looks suspiciously like the index. Investment decision-making is unclear, with responsibilities split up among so many people that nobody is really in charge. The so-called team always looks to the index and they spend a lot of time on portfolio attribution rather than the companies you are investing in when they come to talk to you.

They don't have a handle on the downside risks in the portfolios, though they can probably show you a lot of statistical stuff that they will call "risk controls."

Sound familiar? This manager is too large, too index-oriented and has lost the ability to assess downside risk. All three of our enemies of value added, all arrived at due to business success and logical business decisions, and all very predictable.

So what am I suggesting we do about these issues? Every two or three years, I believe you should devote a session with your investment manager to how his firm is doing as a business. Here are some questions I would ask on our three main issues:

Question #1: Is Your Manager Too Big?

The size issue is pretty easy to address. For Canadian equities or small caps, ask the manager how much they have under management in that asset class, and how that has changed over the past three and five years. Ask if they ever close funds, and if they have any intention of closing the fund in which you are invested. If the growth rate of the assets under management has been rapid, you can assume there are management challenges arising in the business. Ask about growth in headcount, and how they are managing the growth. You should be able to get a handle on whether they are asset managers or asset gatherers from this conversation.

Question #2: Is Your Manager a Closet Indexer?

The benchmark orientation issue is also easy to figure out. I mentioned before that you should get your manager to calculate his active share. If the number is very low, like 30%, you had better be getting a very low fee. In fact, you should examine the possibility of indexing the portfolio just to see how low the fee should be. The active share calculation will tell you how index-oriented your manager is. Your committee will decide on what its comfort level is, and you can go from there.

Question #3: Is Your Manager Protecting Downside Risk?

Downside protection is less easy to estimate. There is something called a Sortino ratio that measures the extent to which a manager is likely to perform badly on the downside, and your consultant may be able to use that. But probably the best test of downside protection is simply the manager's track record in down months, quarters and years. You can probably get a feel for this from their presentations as well. Do they talk about the benchmark all the time, or do they talk about the businesses in which they have invested your money?

Ask who is in charge, who takes responsibility for the whole portfolio. Where does the buck stop? If you can't get a clear answer on this one, the rot goes deep. If they show you a massive group of people with finely divided responsibilities and call it a team, you're really in trouble. At that point the investment process is compromised and your downside may be unprotected.

Summary

My topic focused on three factors that can inhibit your investment manager from achieving value added: size, benchmark orientation and a lack of downside protection. I have also discussed the way investment managers develop over time and the difficulties they face in balancing professional and business success at each stage. The three inhibitors of value added are ultimately symptoms of an underlying disease – the business success of investment management organizations. Business success will often be to the detriment of professional success – and the client's portfolio.

An investment organization that wishes to avoid these pitfalls must make painful choices that can lead to slower growth, which is never entirely popular in the investment management business. Closing mandates before they become too large, maintaining high active share and ensuring that responsibility for decision-making in the investment department remains rational and clear are all things that are very difficult, but essential for value added.

I do not believe that the problems I have outlined are inevitable or irreversible. They are, however, normal in the industry. It is a lot easier for money managers to get it wrong than to get it right. Your job, then, is to remain diligent in examining your investment manager. Hold sessions dedicated solely to an analysis of his business, rather than yours. Identify any of the trends that might lead to his being unable to add value. If you remain diligent, you should be left with a manager who strikes the balance between business and professional success, while continuing to add value in your portfolio.

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Stoicism and the Art of Portfolio Intervention

"A man must think hard and live simply to do well."
Epictetus

Warren Buffett and other successful quality/value investors have given us a capital compounding system that works. But few follow the program. In this issue of *The View from Burgundy*, we will outline some reasons why so few mimic these great investors. For those who want to, we will suggest some investing principles that should be agreed upon before implementing a similar approach. Finally, we will use these principles to develop a portfolio intervention protocol to help us execute the system on a day-to-day basis.

Quality/Value Investing Works – So Why Are There Skeptics?

Buffett's system is simple. Identify a handful of franchise businesses – those with persistent competitive advantages and great management. Wait for them to get cheap, then buy them. And almost never sell. It has worked like a charm, but if it really is so simple, why don't more investors mimic him?

There are two reasons:

1. Some may not agree that this is the best investment system
2. Investors get blown off track while trying to implement it

Let's handle each of these in turn.

First, there are those who may not agree that Buffett's quality/value approach is optimal. Some feel it is not complicated enough. How can anything so simple be the right way to approach something as complex as investing? When we are sick, we would much rather take an expensive batch of pills, with side effects, than eat well, rest and let the body's natural predilection for self-healing work. That is too simple.

The same is true with investing. We would rather jump in and out of stocks and the market, and invest in complex instruments and alternative investments with high fees, because we are convinced that investment success must involve some very sophisticated solutions. By nature, humans are suckers for sophistication.

Second, others who disagree with the Buffett approach feel that they can do a lot better. Humans are famously overconfident – 90% of us think we are better-than-average drivers.[101] The fact that none of us are as rich as Buffett doesn't seem to matter.

Maybe it should. But it is tough to change our minds, even when compelling evidence is presented. Humans tend to prefer their own views and discount anything that does not confirm their biases. Instead we seek out confirming data, even if it is spurious. "I believe therefore I see," [102] rather than the other way around. But make no mistake, the evidence that the Buffett system works is compelling.

The first evidence is Buffett's track record. He has created a $50-billion fortune in one lifetime of investing, from scratch. He has also not been shy along the way about telling us how he's doing it – by owning quality stocks.

Evidence that quality investing works also comes from recently published studies. A paper published in the *Financial Analysts Journal* in 2011 concluded that over the past 41 years, lower-risk (i.e., higher-quality) stocks substantially outperformed higher-risk stocks.[103] A June 2012 white paper by Boston-based investment firm GMO entitled "Profits for the Long Run: Affirming the Case for Quality" came to the same conclusion.[104]

So, even as quality approaches like Buffett's pass the tests of time and academia, many people still retain their own views, expecting that they will be the exception that proves the rule. Most are still waiting.

A final reason people disagree with using the Buffett system is that they cannot sit on their hands. Humans have an overwhelming compulsion to act. For most of us, Franklin D. Roosevelt summed up our core instincts when he famously chided that we should, "least of all, do *something*." The Buffett buy-and-hold system, which relies on a large dose of "lethargy bordering on sloth," seems counterintuitive. Instead, we are programmed to take action, despite the evidence that almost all of our investment actions subtract value.[105]

Let's now turn to those investors who buy into Buffett's simplicity, but get blown off course. There are lots of things that can upset the investing apple cart, like macro events causing perceptions about increased investment risk, volatility in asset and stock prices, and expert advice and predictions contrary to our plan. They could sidetrack Buffett too, of course, but they don't. He seems to understand when to perform a portfolio intervention and when to stand pat.

In *Antifragile*, the follow-up book to *The Black Swan*, Nassim Nicholas Taleb made the point that in modern life a great many expert "interventions" – whether in medicine or economics – subtract value, despite the intervener's best intentions.[106] Taleb calls these mistakes "naive interventions."

Taleb also suggested that what is needed is a systematic protocol to help us make "non-naive interventions." Buffett's success is helped by his use of such a tool, even if it is subconscious. For the rest of us non-Buffetts, a portfolio intervention protocol could help us deal with the day-to-day portfolio pressures. Let's take Taleb's advice and develop one.

Four Underlying Investing Principles

The first step in our protocol development is to agree to the facts and assumptions underlying the Buffett approach. If we cannot agree on the basics, then the quality/value system is not for us.

1. **Long time horizons are absolutely necessary.** If we want to earn returns that are better than bond yields, then we need to adopt the very long time horizon that is appropriate when investing in stocks. If that is not possible, then this is a signal to opt out of the Buffett system.
2. **Earning equity returns without being exposed to equities is impossible.** We must own equities to earn equity returns. Expecting to jump in at market bottoms and out at tops is unrealistic and risky because equity returns are discontinuous. We don't want to miss the few really big "up" days. While there may be many ways to get to heaven, there are no shortcuts.

   Success at "timing the market" could only come from success at repeatedly predicting the short-term future. In a complex, adaptive world where any spontaneous order is temporary and many of our earthly systems are often operating at the edge of chaos, predictions about the future are more difficult than they seem. Repeatedly getting them right is impossible. In financial markets, as in life, surprise is the rule, not the exception.

   We are not aware of any study or long-term track record concluding that anyone has repeatable expertise in market timing. Even Buffett likes to say he attempts to price, rather than time, his investments. Again, if we cannot agree with being long-term stock owners, here is another chance to opt out of this approach.
3. **Quality stocks are the only way to go.** While there are always a few who get lucky guessing on speculations, there are many more who lose it all. We must agree that only quality franchise companies with persistent competitive advantages and strong management will be owned.
4. **A buy-and-hold approach is best.** We will buy these quality franchises when they are cheap, with the plan to hold them forever if nothing changes.

Our long-term investment success will be decided by how well we honour these principles. Rest assured: our commitment to these principles will be tested. Markets will fall, economies will recess and experts will constantly advise us to get out of the market. With reference to these principles and our concomitant intervention protocol, we will be able to withstand the pressures and stay on plan.

The Principles Help Us Withstand the Pressure to Act

With these principles serving as a template, let's go back and consider some pressures – macro risk, market volatility and contrary expert advice – that can potentially knock our system implementation off track.

Let's start with the big picture. Many feel that the macro world is more uncertain and risky today than ever before. The implication is that portfolio exposure to equities should be limited as a result. What do our underlying principles tell us?

Our principles conclude that if we want equity returns and have adopted the appropriate long time horizon, we need to own equities. Full stop. Consider the macro uncertainty and risks Buffett experienced in his 60 years of investing: a world war, hyperinflation, oil shocks, recessions, etc. He never wavered, and if we stick to our principles, neither will we.

So as far as our first outside pressure – macro risk – goes, we can ignore it. Why? We have agreed to invest only in quality companies for this very reason: they are robust and can adapt to whatever the macro environment throws at them. This is why they outperform over the very long haul.

But what about market volatility? After the market crash of 2008, many investors just don't have the stomach for it. Again, let's go back to our principles. They say nothing about volatility. Buffett lived through a lot of that too – including historic bear markets in the early 1970s and 2000s as well as the crashes in 1987 and 2008. In fact, rather than change our plan, volatility is a source of tremendous opportunity. Our principles state that we should buy our quality franchises when they are cheap. Rarely are these companies as cheap as they are during times of market volatility.

So as far as volatility goes, we can ignore that too, except where it provides a buying opportunity.

The last pressure occurs when "experts" offer us advice and near-term predictions that run counter to our principles. Let's get short-term predictions out of the way first, as they are all useless. Complex, adaptive systems like our world and financial markets will always be uncertain and unpredictable. Anyone who attempts to tell you any different has an axe to grind.

Looking forward from any point in time, the immediate future is always uncertain. Historically, investors in equities have been well-compensated for this over the very long term. This is the reason that our principles insist on equity exposure. Riding out the uncertainty and volatility is simply the entrance fee that must be paid to win the long-term prize.

As far as other advice goes, we all are subject to an overwhelming amount of information and data, almost all of which is meaningless noise. When noise is mistaken for valuable information, this can easily knock us off course.

The investment industry doesn't help. Indeed it feeds off of clients' anxieties. Most industry advice and chatter is just noise designed to part clients from their money.

In many other instances, we are fine living in a noisy world, and remain able to focus on our objectives – working, raising a family, etc. – without too much distraction. It is even pleasant to seek out a little distraction like a favourite TV show to unwind with after work. And some cannot sleep without white noise – the constant background hum of the modern world.

But the investment industry works very hard to tie us into the noise trap. The industry makes gargantuan profits by perpetuating its own form of noise – we call it "green noise" given all the commissions and fees industry players coin from promoting client activity.

In the short run it may not matter if the noise is wrong or ridiculous – all the industry needs is enough customers who don't know any better. One look at industry profits and compensation suggests that there are more than a few of these customers around.

So just like with the other pressures, the vast majority of industry advice, predictions and other noise can be safely ignored.

Blocking Out the Noise: A Stoic's Approach to Investing

> Think of how good it would feel to be indifferent to the vast majority of investment hype and noise around you. A useful model is that of the Stoics, especially those who lived in the first few centuries AD, and were led by Epictetus.
>
> By understanding what was irrelevant and outside their control and learning to ignore it, the Stoics were able to lead wilful lives characterized by self-control and fortitude. By being totally indifferent to anything that wasn't within their control or relevant, they were able to live lives filled with "tranquility, fearlessness and freedom." Sounds good to us.

The Principles Form a Protocol for Portfolio Intervention

After applying our underlying principles, we should ignore almost everything that we read and hear about the stock market, economy and "expert" advice. But there are a few instances when we should take action, and discussing these appropriate interventions will help us round our principles into a clear intervention protocol. We will then understand what kind of information we should be paying attention to. Importantly, the "non-noise" that can lead to "non-naive interventions" is on a company-by-company basis.

There are three scenarios in which a portfolio intervention is justified:

1. **Valuation.** If a stock holding becomes excessively valued, it may warrant sale. Valuation is a judgment call, and we will do our best to heed Buffett's aim to be "approximately right rather than precisely wrong." In some cases Buffett has held on to seemingly overvalued shares, while in others he has sold them. For our protocol, it is enough that we highlight excessive valuation as a filter to force us to make the decision to sell or hold.

   The inverse is just as true. When one of our franchise businesses is undervalued, it should be bought. As valuations at the beginning of a holding period are the key determiner of eventual investment returns, taking advantage of cheap stocks is critical to our long-term success.

2. **Changes in competitive advantages.** When the "moat" around a holding's economic castle begins to fill in, it is often time to sell. This is another filter we can apply to our industry research. And new moats can emerge, giving us potential franchises to study. We will watch closely for changes in industry and competitive dynamics.

3. **Changes in senior management.** Famed Fidelity fund manager Peter Lynch has said that he likes to own businesses even an idiot can run because one might take over. Management changes are another filter to take note of, as it might lead to an appropriate portfolio action.

So there we have it – a portfolio intervention protocol that comes directly from our investment principles: ignore everything unless it impacts our portfolio companies' valuations, competitive advantages or senior management. We can now use the protocol as a template to extract useful data from the overwhelming information and noise.

Adhering to this protocol should help us implement a simple Buffett-like approach to investing. But even this new tool won't make it easy. The approach – identifying a handful of franchise businesses, waiting for them to get cheap, then buying them and almost never selling – is hard work. Doing it well takes a tremendous amount of focus and attention.

It is a lot easier to do it poorly or get sidetracked if we are overwhelmed by constant streams of noise and irrelevant information. Our portfolio intervention protocol will help us ignore all of the distractions and leave more time for the essentials of implementing the approach. Like Taleb says, it is not optimal if when crossing the street you miss the truck coming because you are observing the different eye colours of fellow street crossers.

Indeed, the essence of a quality/value approach is one of reduction. The number of franchise companies that meet the quality criteria is limited. The number of these that are cheap enough to buy is fewer still. We can only make these decisions robustly if we are paying attention only to what we need to know, but no more. Understanding the difference is what separates Buffett from the rest of us. This is where our portfolio intervention tool can earn its stripes.

Implementing a Quality/Value Approach

Let's recap. Investors aiming to implement a Buffett quality/value approach should first agree on the following investment principles:

1. Adopt a long enough time horizon
2. Owning equities is the best way to compound capital
3. Quality stocks are the only way to go
4. "Buy cheap and hold" is the method

If we cannot agree with these, then the Buffett system is not right for us.

We used these underlying principles to develop a portfolio intervention protocol to help us understand what can be safely ignored – and what must be the focus – in a world where we are inundated with information, most of it useless. In a nutshell: ignore everything unless it impacts our portfolio companies' valuations, competitive advantages or senior management. If we follow our protocol, then tranquility, fearlessness and freedom – worthy of a Stoic – are sure to follow.

How will we know when we have arrived? When we perform fewer portfolio interventions, we are halfway there. And we will be even closer when we realize – upon hearing others fret of recession fears, market volatility and experts telling them to get out of the market – that we are truly indifferent to it all. Because by using a quality/value approach – aided by our protocol – our portfolio will be set up in such a way that we wouldn't do anything different anyway, regardless of the volume or content of the noise.

Author: **David Vanderwood, Senior Vice President and Portfolio Manager for Canadian equities**

July 2014

Confessions of a Buffetteer

Richard Rooney, President and CIO of Burgundy Asset Management Ltd., delivered the following presentation at the London Value Investor Conference on May 22, 2014.

The value investing tent is inhabited by several different tribes: the Orthodox, the Bears, the Gold Bugs and the "Buffetteers." These groups are united by a common admiration for Ben Graham, the first and still the greatest proponent of the philosophy, but far from unanimous on some other things.

The Orthodox

The largest group, and the original inhabitants, practise the orthodox statistical-value method of scouring the markets for the dollar bill trading for 50 cents, and owning a diversified portfolio of cheap securities. This is a reliable way to invest with a margin of safety and produce good returns over the long term. Most of these value investors look to the masters of this approach for their methods. Ben Graham, William Ruane, Walter Schloss and Peter Cundill are their models, though almost all of us lack the flexibility and creativity of these exceptional investors. Please recognize that I am not using the idea of orthodoxy as a pejorative; rather, it is the mainstream from which the others derive.

The Bears

As the name implies, the bears approach the market with characteristic pessimism. Usually espousing the doctrine of statistical cheapness, but overlaid with macroeconomic disaster scenarios and a healthy dose of Oswald Spengler, these folks never find a market cheap enough to be fully invested. Any crisis is assumed to be a prologue to catastrophe; and therefore, even better values always wait. As a consolation prize for never being fully invested, bears have an acute sense of absurdity, which makes them among the most penetrating and hilarious critics of a business that can always be relied upon to create fresh absurdities. And, as part of the old saying goes, bears do make money.

The Gold Bugs

Gold bugs are usually also accorded a section of the value tent. It is entirely understandable that people obsessed with value should worry about the value of their units of account. As we all know, Ben Graham was disturbed by the tendency of governments to debase the currency and several times presented his idea of the ever-normal granary to congressional committees. So, this concern with monetary integrity has deep roots in our philosophy. The deep concern for permanence and inflation protection means gold bugs can have unique insights and, like the rest of the tent, make money.

The "Buffetteers"

Finally, there is a group that the others tend to look upon with a certain suspicion. These investors own equities that often trade at multiples of book value, and whose balance sheet accounts rarely support the market valuations of their investments. They incorporate some assumptions about future earnings into their valuation work. They tend to own concentrated portfolios of high-quality companies with low turnover. These are the investors that I label Buffetteers, and among whom I number myself.

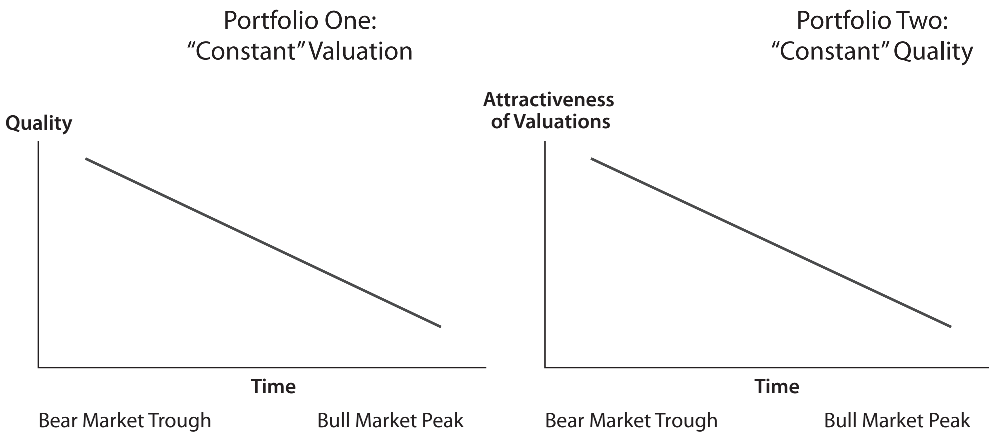
A large number of value investors are conflicted about Warren Buffett's legacy. They cannot deny his closeness to Benjamin Graham, since he was literally Graham's student at Columbia, and the only student to whom Graham ever gave an A+ in his course; he was an employee of Graham-Newman, that incubator of great value investors; and he was a lifelong associate and admirer of Mr. Graham. He is also the most successful investor of all time, and the only one who became one of the world's richest people mainly by compounding capital in the public securities markets. So certainly nobody wants to disown him.

But Buffett's methods are very different from those outlined by Graham and Dodd. They are so different that some more orthodox value investors find them rather suspicious, and tend to treat Buffett as a one-off – a brilliant but wayward disciple whose methods were peculiarly suited to one specific place and time, rather than as the exemplar of a legitimate branch of value investing. I was trained in a deep-value Graham shop, but migrated later to the quality-value approach, so I have always sought ways to reconcile the statistical- and quality-value camps.

I do not speak for Mr. Buffett in any way. I have attended his annual meeting in Omaha on eight occasions, but he doesn't know me from Adam. And our capabilities are not remotely comparable. In fact, one of the titles I considered for this topic was "Trying to Invest like Warren Buffett when you're not Warren Buffett." But then, all of us are trying to live up to the giants of our field and few, if any of us, will measure up.

My task today is to present what I consider to be the principles of the quality school of value investing, and to show its line of descent from the teachings and experience of Benjamin Graham and Warren Buffett.

CONSTANT VALUATION AND QUALITY



Constant Valuation vs. Constant Quality

I invite you to undertake a thought experiment with me.

Consider that you are running two portfolios. In one portfolio, you propose to keep low statistical valuations constant throughout the market cycle, adhering rigidly to a program of low price/earnings ratios (P/Es), low price/book ratios, etc. In the other, you wish to keep quality constant, as measured by strong balance sheets, high returns on invested capital and low volatility streams of free cash flow.

Assume that you start the process in a bear market trough, when there are plentiful undervalued stocks in the capital markets. There may initially be some overlap in the portfolios. But as the bull market unfolds, the portfolios will diverge in several respects.

In the statistical-value portfolio, as price targets are reached and multiples expand, the manager must scour ever deeper for discounts of all sorts. Activity can be quite high in this portfolio. As the risk preference of the market rises, by the late cycle it is only risky securities that remain cheap and it is likely that there is a decline in the quality of the statistical-value portfolio over time. Remember, I am making this a purely statistical exercise so this portfolio will never see a discount it does not like, be it due to cyclicality, complexity, secular decline, managerial incompetence or geopolitical tensions.

In the quality portfolio, some positions will be falling by the wayside as the relentless forces of capitalism lay siege to businesses through technological change, shortened product life cycles or globalization. In the case of American companies, managements will be pillaging the business and diluting shareholder value through their compensation arrangements. Turnover will be lower than in the statistical-value portfolio, but valuations will tend to rise significantly from the trough of the market. Given the rather homogeneous nature of the quality investment universe, there are very few pockets of opportunity to improve valuation in the portfolio without sacrificing quality.

Consequently, in one portfolio, if statistical valuations are held constant, quality declines. In the other, where quality is held constant, valuation suffers.

This brief and highly simplistic parable seems to sum up the gulf that separates statistical-value investors and quality-value investors. I believe both approaches, when capably implemented, will produce excess returns for investors and I also believe that both these approaches can be traced back to the methods and investment experience of Benjamin Graham. As an opening argument, let me quote from Chapter 20 of *The Intelligent Investor*:

> "The risk of paying too high a price for good-quality stocks – while a real one – is not the chief hazard confronting the average buyer of securities. Observation over many years has taught us that the chief losses to investors come from the purchase of low-quality securities at times of favorable business conditions."

Clearly Mr. Graham undertook our thought experiment long ago.

Investors who focus too much on quality and not enough on valuation can end up with no margin of safety in their investments. In the Nifty Fifty market of 1972 and the quality mini-bubble of summer 1998, valuations of quality companies became extreme. As a result, a buy-and-hold portfolio of quality stocks underperformed for several years afterward, before advancing beyond the price levels reached in those years. But even in those two extreme cases, the strong business characteristics of the companies usually ensured that quotational losses were eventually reversed, and long-term returns were satisfactory.

But investors who focus too much on statistical-value and not enough on quality can find themselves in an even worse position. The last business cycle gives us a great example of this. In 2007 and 2008, many statistical-value buyers tended to own a lot of financials and credit cyclicals that were statistically cheap, and commodity cyclicals with low P/Es. Such investors often lost more money than the market averages in the downturn, frequently taking irreversible losses on their positions.

A calculation of margin of safety that does not sufficiently consider quality is at least as risky as a calculation that relies too much on quality and not enough on valuation.

GEICO: an Example of the Quality-value Approach

I promised earlier to show how the quality-value approach derives from the Graham tradition.

The key lies in Ben Graham's investment in GEICO, and especially in his analysis of it. GEICO is a somewhat disturbing aspect of Graham's career for the orthodox. He appeared to violate several of his most sacred tenets in the GEICO case.

To recap, in 1948, Ben Graham was offered a chance to purchase 50% of GEICO, a direct seller of insurance that concentrated its marketing on government employees, who were proven lower risks. He put 25% of the Graham-Newman partnership's capital into the investment. Forced by regulators to spin off the shares to his investors shortly thereafter, it became one of the investment wonders of the world. As Graham wrote in the late 1960s:

"It did so well that the price of its shares advanced to 200 times or more than the price of the half interest… almost from the start the quotation appeared much too high in terms of the partners' own investment standards. But since they regarded the company as a sort of 'family business' they continued to maintain substantial ownership of the shares despite the spectacular price rise… Ironically enough, the aggregate of profits accruing from this single investment decision far exceeded the sum of all others realized through 20 years of wide-ranging operations in the partners' specialized fields, involving much investigation, endless pondering and countless individual decisions."

I believe that unsparingly honest paragraph contains the germ of a new way of thinking about investing. There are three striking things I take away from the GEICO story.

First, the size of the investment. Graham was normally adamant on the subject of diversification, suggesting that investors own at least 30 securities in their portfolios, and usually owning up to 75 positions in Graham-Newman portfolios. Buffett, of course, famously referred to diversification as "a defence against ignorance" and proudly concentrates his investments to an unusual extent in securities he believes he understands.

Second, there is the brilliant way Graham reasoned his way to holding the position despite higher valuations than he was normally comfortable with. He decided to treat the investment as a family business. This is elegant. Looking around the world at great fortunes built on free capital, the norm is family ownership of large positions in companies with superior economics. Buffett has prioritized his investments the same way, once referring to three of his positions as, "a permanent part of Berkshire rather than merchandise to be disposed of once Mr. Market offers us a sufficiently high price."

Of course, one of those three investments was GEICO.

Finally, there is the rather wistful remark about the return from this one decision versus that on 20 years of constant labour and frequent decisions. Here, I believe, is the genesis of the idea that fewer decisions can be better. Buffett popularized this idea by saying that if everyone had a 20-punch bus ticket of lifetime investment decisions, our decision-making would be much better.

Graham has another sentence in his assessment of the GEICO story, one that any investor would be wise to take seriously:

"Behind the luck, or crucial decision, there must usually exist a background of preparation and disciplined capacity."

To recognize and take advantage of opportunities, the intelligent investor must be familiar with, and able to apply, the basic techniques of value investing. I do not feel that anyone can successfully practice the quality-value approach if they are not fully trained in Graham and Dodd valuation methods.

GEICO Takeaways

So what can we learn from the GEICO story, both Chapter One by Ben Graham and Chapter Two by Warren Buffett?

First of all, there is concentration of positions. I mentioned above that Buffett once said, "Diversification is a defence against ignorance."

He is not known as the "Oracle of Omaha" for nothing. And like the oracles of old, his utterances can be read in several different ways. This one, it seems to me, can be interpreted as a warning as well as a pejorative. The average investor cannot be expected to bring the same level of knowledge and skill to his decisions that Buffett or Graham did – not even close. In any position one enters into, there will be huge areas of ignorance for the average investor. That doesn't mean he should not do his utmost to correct the situation, but concentrating investments as much as Buffett does routinely, or Graham did in his GEICO position, is not for everyone.

Quod licet Iovi, non licet bovi.[107]

The norm at Burgundy is a portfolio with about 20 to 25 equities represented. It seems to work for us.

Second, there is the buy-and-hold preference. This one is particularly troublesome to our statistical-value colleagues, since we can appear insufficiently contrarian and value conscious. Great companies are not always great investments. For example, Gillette reached a price in 1998 that was about the same price as Procter & Gamble paid to acquire the company five years later. Clearly, there was no margin of safety in 1998, and investors should be willing to sell investments where there is no margin of safety. However, a quality company can be held almost indefinitely as long as there is some margin of safety; a great deal more patience should be exercised with an excellent company than with a company whose economics are inferior.

Related to the buy-and-hold preference is the bias against transacting. Transactions always involve costs and the buy-and-hold strategy is a very low-cost way to compound capital. Recent revelations have confirmed that trading today hugely benefits parasitic intermediaries. Inactivity has never been more satisfying.

Finally, it is clear that the very best quality investments are made when they are also compelling value investments. In 2009, when we saw some of our deep-value friends loading up on high-quality stocks, we knew we were going to make a ton of money for our clients. When everybody in the value tent is on the same page, the results will usually be excellent.

Burgundy in Japan

As an illustration of this truth, I would like to talk about Burgundy's experience in Japan, which has been both instructive and reasonably profitable. We have made more money in Japan over the past 10 to 15 years than we have in U.S. large caps, and vastly more than if we had invested in a broad-based index of Japanese stocks. A big reason for that was that we got off to an absolutely wonderful start, thanks in large part to Peter Cundill.

My business partner, Tony Arrell, had dinner with Mr. Cundill in late 1997. Peter was very excited about the values appearing in the Japanese market, and of course he was a man whose excitement about investment opportunities was highly contagious. As it happened, Tony and I had been looking for an opportunity to expand our investment footprint outside North America.

All of our clients were Canadians in those days, and Japan is as different an economy from Canada's as you could find. So we felt Japan would offer great diversification to Canadian investors, as well as a great value opportunity.

In 1997 Japan, there was a full-scale financial crisis in progress. An indiscriminate bear market had taken Japanese equity valuations to extraordinarily low levels. This appeared to Tony and to me as a perfect opportunity to start our foreign equity investing in a low-risk fashion, with investments whose prices did not remotely reflect either asset values or earnings power.

Accordingly, we set off for Japan and spent most of January 1998 in that country. It was a rather depressing trip. I had forgotten how obtuse Japanese managements could be, and how little they cared about shareholders. Clearly there would be major obstacles to applying the quality-value approach there.

On the way back to Canada, I started sifting through the Japan Company Handbook, that invaluable aide to Japanese investing for the foreigner. I was immediately re-engaged as I began to realize what a treasure trove of value the Japanese small- and mid-cap areas were.

Bearing in mind Buffett's warning about diversification and having some idea of the extent of my ignorance, I decided to set up a portfolio of 60 stocks, of which 20 would be net-nets,[108] 20 would be cash-heavy low-multiple companies that had been able to grow sales and earnings over the previous five years, even if only slightly, and 20 would be better known, larger-cap issues trading at low earnings multiples.

There were about 1,800 issues trading at or below net-net working capital in Japan at that point. We were able to steadily raise the bar on the quality of the net-nets. We could, for example, require that a company have at least 40% net-net cash, have not had a loss in the preceding five years and have earned a return on equity (ROE) of at least 5% over that span. It was, in a phrase, hog heaven for a value guy.

In March we hired Craig Pho, who acted as Analyst on the Fund until mid-2001 when he assumed control of the portfolio. When he joined, I told him our dirty little secret: we were profoundly ignorant and needed some years to get up to speed.

We got six months. In the autumn of 1998, the Japanese government injected capital into the remaining Japanese banks and engineered mergers for the weaker ones.

The stock market went vertical. By September 1999, the one-year return in our Japan Fund was 130.2% (in Canadian dollars), still an all-time record one-year return for a Burgundy fund. Thank you, Peter Cundill.

Generally, the larger companies in the portfolio were a bust. They did not appreciate to anything like the extent of the small- and mid-cap names. The better quality net-nets performed very well, while some of the very deep discount working capital net-nets did not do much. The real revelation was the small growing companies we had added to the portfolio. For example, Park 24, a parking lot company in Tokyo, went from ¥1,440 to ¥8,000. Colin Corporation, a small manufacturer, went from ¥900 to ¥9,720. Wildest of all was a tiny company called Drake Beam Morin Japan, which got hyped as a play on Japanese outplacement. We bought it in July 1998, when its market cap was about US$30 million. We sold it in April 1999 at seven times that price and it almost tripled again by the autumn.

Of course we had to sell all these stocks. After 1999, the Japanese market went into a long funk. The unit value in our Fund did not get back to autumn 1999 levels until 2006, and finally breached them decisively in March 2010. You need patience to play in Japan.

But the first year had set the tone for our strategy. We played high-quality net-nets when we could find them, which was less and less frequently over time. We tried to find cash-rich companies that had been able to grow their businesses and, where we could, engaged the company managements in discussions about capital allocation. Despite some glaring exceptions, we believe capital allocation in Japan has improved almost beyond recognition. Share buybacks and dividends have been more and more generous among our Japanese portfolio companies, with good performance effects.

As our ignorance diminished, our portfolios became more and more concentrated in high-quality and well-managed Japanese companies. These do exist, though they are uncommon. Our all-cap portfolio, which has a small-cap bias, today contains 34 equities, while our portfolio with a minimum market cap of US$1 billion contains only 15.

In the 16 years to March 31, 2014, our Asian Equity Fund[109] has returned 8.3%. The benchmark MSCI Japan Index has returned 1.0%. The absolute numbers may not be that impressive, but they are better than the 16-year return on the S&P 500 Index, which has returned 3.7% to Canadian investors over the same period. I include this information since the S&P 500 is the gold standard among benchmarks worldwide from a quality standpoint, and I think outperforming it over the long term with Japanese assets is a decent accomplishment.

BURGUNDY IN JAPAN

	1 Year (%)	5 Years (%)	10 Years (%)	16 Years (%)
Burgundy Asian Equity Fund	21.8	13.5	5.7	8.3
MSCI Japan Index	17.1	7.7	0.6	1.0
S&P 500 Index	32.4	18.0	5.6	3.7

Annualized as at March 31, 2014 — Reported in C$, gross of fees

Our investment in Japan has really done the job from a diversification standpoint. In 2008, when worldwide stock markets were plummeting, the yen strengthened against the Canadian dollar and our Fund returned positive 17% (in Canadian dollars) in that year.

While the currency effect was overwhelming, our Fund outperformed the Japanese index by 26% that calendar year. The quality approach has been quite reliable as a downside protector. There have been 180 monthly year-over-year measurements since we launched the Fund in February 1998. Of those, 87 showed negative year-over-year results for the benchmark. So, more than 48% of the time we were investing in a market that was down year over year. In 82 of those cases, or 94% of the time, when the annual market return was negative, the one-year return from the Burgundy Fund beat the benchmark return with either a smaller loss or an actual gain. Our quality investments have effectively protected our clients from the frequent and extensive downside in Japan.

Our impression is that many investors, who flocked to Japan at about the same time we did, had very negative experiences and often found that the market remained irrational longer than their clients could remain patient. In a country where there is no market for corporate takeovers, where businesses are run for the employees or communities instead of shareholders, where growth is too slow to act as a catalyst and where financial sophistication is amazingly low, many of the normal value arbitrage functions are simply not active.

This would be the time for me to show you a really great current investment in Japan. Would that I could. The extraordinarily aggressive monetary policies of the Abe government have led to a massive lift in Japanese equity prices. Whereas Japan was reliably the best value of all Burgundy's geographies for many years, today our margin-of-safety work shows it to be the most expensive. Our cash positions are rising to levels that are historically high for us.

Conclusion

My goal was to show that the quality school of value investors, despite our obvious differences in portfolio construction and behaviour, is based on the principles of Ben Graham, including and most importantly the principle of margin of safety. It derives from the experiences of both Graham and Buffett, particularly from the GEICO case. When applied with discipline and constant attention to valuation, the quality-value approach allows above-average capital compounding at low cost, and has proven to be successful at protecting the downside of our investors.

To illustrate our approach, I have used the example of our effort in Japan, which gave us an unusual opportunity to use the statistical-value approach as a starting point and migrate to our quality-value approach as we gained in experience and knowledge. The statistical-value approach gave us a protected downside when we started off and unusually good returns when a crisis ended. But even after the extraordinary undervaluations disappeared, the performance of quality Japanese companies has continued to allow us to compound capital for our clients, largely through protecting their downside.

I believe this means we are consistently investing with a margin of safety, and that kind of investing, whether you are a deep-value investor, a bear, a gold bug or a Buffetteer, is the hallmark of a value investor.

Author: **Richard Rooney, President and Chief Investment Officer**

September 2014

Top Quartile: A Survey of Canadian CEO Compensation Programs

In 1998, we wrote about the unintended consequences that options have on manager behaviours in an issue of *The View from Burgundy* entitled “Stealing a Fortune.” We illustrated our thoughts with a story about two companies: Excellent Corporation and Subpar Corporation. Excellent Corp. motivated its CEO (Mr. Topnotch) with a bonus tied directly to share ownership, while Subpar Corp. offered options to its CEO (Mr. Hohum). Excellent Corp. went on to outperform Subpar Corp. through a combination of better capital allocation and better business decision-making.

In the years that followed “Stealing a Fortune,” we supported stricter accounting rules, arguing that rational accounting treatment for stock options might temper reliance on stock options and improve alignment between managers and shareholders. In 2004, we were thrilled to witness new accounting rules take effect in Canada, which required public companies to expense stock option compensation through the income statement; however, we have been unimpressed by companies’ subsequent abuse of non-GAAP (generally accepted accounting principles) metrics like earnings before interest, taxes, depreciation and amortization (EBITDA) to conceal stock option compensation with the tacit concurrence of some research analysts. In this issue of *The View from Burgundy*, we revisit stock options, surveying Canada’s 60 largest companies to understand how stock options are being used a decade after the changes in accounting rules.

A Tale of Two Board Members (and One Advisor)

Topnotch and Hohum are now retired from their corporate manager jobs, and have recently taken up posts on the board of New Corp. to occupy their spare time. At the first board meeting, the duo is charged with the daunting task of designing a compensation package for New Corp.’s CEO, Mr. Newguy. The compensation committee is meeting in two days, so the panicked duo hires a consultancy, Good Governance Advisors, to help them. Topnotch and Hohum ask the lead partner at Good Governance, Mr. Fairpay, to make a presentation to them the next day.

Fairpay quickly puts his research analysts to work analyzing the compensation programs of New Corp.'s Canadian peer group, the constituents of the S&P/TSX 60 Index. "It is going to be a long night," Fairpay mutters as he begins preparing his speaking notes.

Early the next morning, Fairpay reviews the finished presentation in his office over a much-needed coffee. As he scans the charts, he is astonished at the impact compensation programs have on the behaviour and share ownership of CEOs. "The influence is even stronger than I had guessed," Fairpay says to himself. A ringing phone jolts Fairpay away from his thoughts. "Topnotch and Hohum are here to see you," the receptionist tells Fairpay. "I'll be right there," Fairpay responds absent-mindedly as he ponders the gravity of his team's findings. After a few more minutes, Fairpay finally pries himself away from the presentation and leaves his office.

"Thank you for coming," Fairpay says to the couple as he enters the boardroom. "My team worked all night to get you some answers. I think we've arrived at some very interesting conclusions."

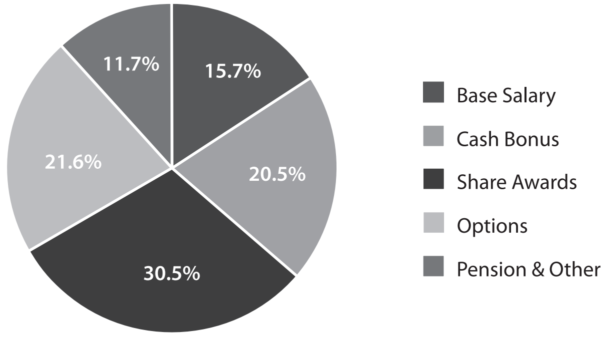
Fairpay hands Topnotch and Hohum copies of the presentation, instructing them to refer to slide 1.

Compensation Packages

"As you can see, the average CEO of a large Canadian company has a diverse compensation package," Fairpay starts. "About half of the compensation involves equity, while the other half is cash and benefits like pensions. Of the equity compensation, share awards are more popular than stock options."

Looking confused, Hohum asks, "You mean options aren't the only way to give managers equity?"

BREAKDOWN OF AVERAGE CEO COMPENSATION PACKAGE



"No," Fairpay clarifies, "share awards are another way. These awards usually take the form of restricted stock units (RSUs).[110] RSUs are a promise by an employer to issue stock to an employee at future vesting dates. Though they are imperfect, share awards are recommended over options by the partners at Good Governance. We prefer share awards because the recipient participates in the upside and the downside of the company's stock price performance. However, for the best management-shareholder alignment, nothing is better than CEOs investing their own wealth in company shares."

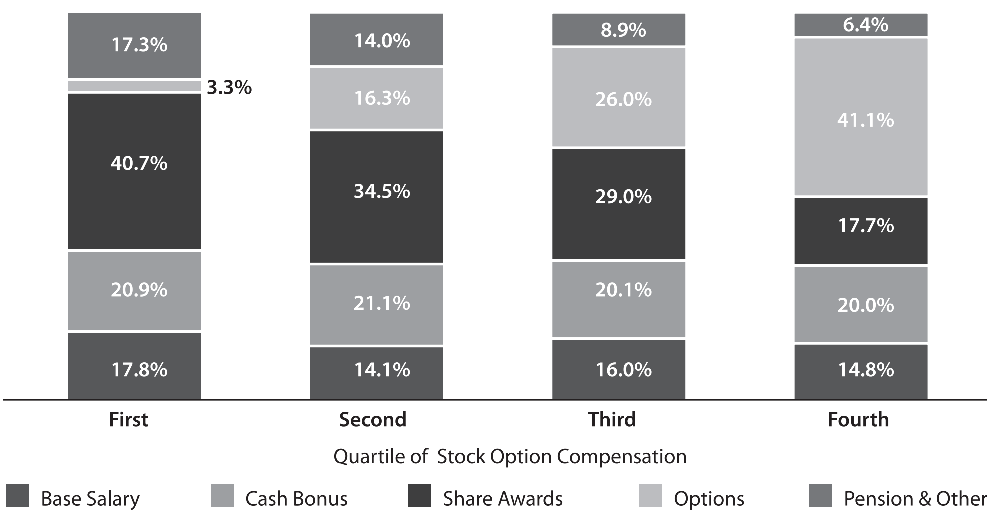
Surprised, Hohum nods his head and stares at the pie chart in silent disbelief.

Option Compensation Quartiles

"On the second slide, we have analyzed the dispersion of equity compensation programs across New Corp.'s peer group," Fairpay proceeds.

"We organized the peers into quartiles, ranked by the percentage of overall compensation offered in stock options. After a closer look, we discovered that some companies offer their non-cash compensation mainly in share awards and pensions, as you can see on the far left, and others offer the majority of their non-cash compensation in options, as you can see on the far right."

CEO COMPENSATION BY OPTION COMPENSATION QUARTILE



"This is all very interesting," Topnotch says, scratching his head, "but what should we tell our compensation committee about the best way to give equity to Newguy? Which one of these is the top quartile?"

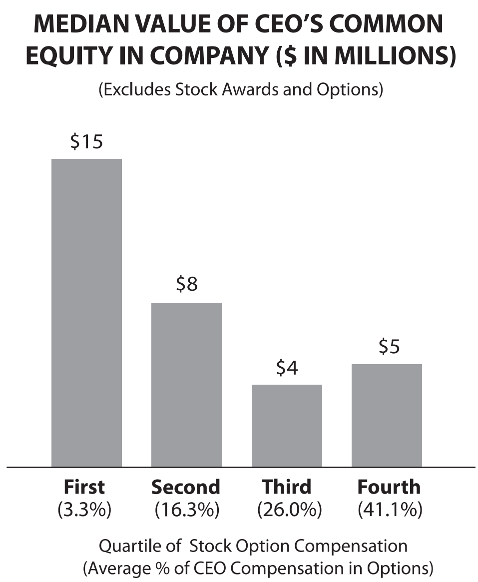
"I was hoping you would ask that," Fairpay says confidently as he flips to the next page of his slide deck.

Common Equity Ownership

"A good compensation committee will want to know the best way to get Newguy to act like a business owner. The best way to get CEOs to act like owners is to make them owners," Fairpay says knowingly as he points to the left side of the slide. "Our research shows that stock option compensation levels are inversely correlated to CEO ownership levels. The median first-quartile CEOs have $15 million of common stock invested in their companies. This number excludes the value of options and stock awards – it is true common equity ownership. We believe that option compensation is inversely correlated with ownership for a practical reason: the taxes triggered by a stock option exercise often motivate holders to sell their shares." [111]

"Well of course," Hohum interjects. "Back when I was a CEO, every time I exercised my options, I had to sell shares to pay the tax man. What was I supposed to do?"

"Exactly," Fairpay continues. "So, we think options do a poor job of encouraging CEOs to stay and build equity at their companies. The first-quartile companies in our survey offered significantly larger pensions, instead of options, which we hypothesize encourages CEOs to think about their careers with a greater sense of permanency."



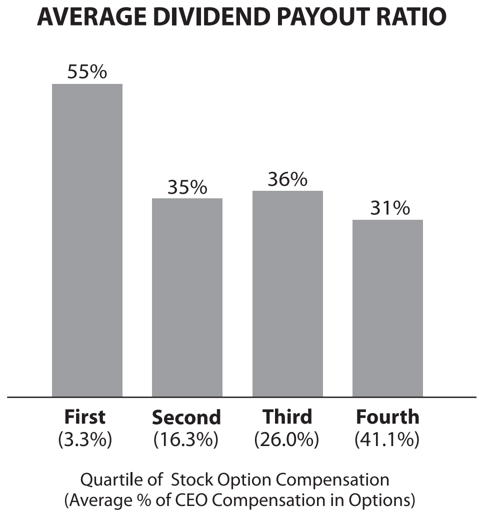
Manager-shareholder Alignment

By this point, Fairpay worries that the duo's attention is waning. He moves to close out his presentation with one final slide.

"But why," queries Fairpay, "should shareholders care about CEO alignment?"

Topnotch laughs at what he perceives to be a rhetorical question while Hohum gazes questioningly at the slide.

"Because it affects capital allocation," answers Fairpay. "An option-holding CEO is incentivized to only direct shareholders' capital toward activities that can increase the share price in the short term. This activity often takes the form of share buybacks. While we recognize that share buybacks can create considerable long-term value for the continuing shareholders in a company, they must be conducted at a low price to be effective. Unfortunately, options incentivize managers to conduct buybacks whenever the company has extra cash flow. Paradoxically, this means that an option-motivated CEO may buy back company shares at the top of the market."



After pausing for a moment to let Hohum catch up, Fairpay continues. "On the other hand, an owner CEO is more likely to return capital to shareholders through dividends when there are no better uses for the capital," Fairpay explains, waving his hand at the left side of the slide. "I suspect owner CEOs may also be more likely to make the long-term investments their companies need to sustain competitive advantages."

"Some stock awards are designed to participate in dividends, which strengthens the propensity to return capital through dividends when it is appropriate," Fairpay says in his final assertion. "You can see that on this last slide, which shows that first-quartile companies paid almost twice as much of their earnings out in dividends as fourth-quartile companies."

Sensing his work is done, Fairpay closes his presentation book and begins, "So maybe this is a good time to discuss Good Governance's fee schedule?"

Conclusion

While the concepts in Fairpay's presentation are simple, we keep them top of mind as we make investment decisions. The topic of CEO compensation reminds us of a Warren Buffett quote: "The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs." Though we are encouraged by the fact that options now account for only one-fifth of the average Canadian CEO compensation package, we remain wary of some imprudent compensation committees that still offer their CEOs the wrong incentives.

In closing, Burgundy's investment principles as they relate to a CEO's ownership, capital allocation policies and compensation include the following ideas:

- We look for CEOs' *common equity* ownership as an indicator of an owner-operator disposition (ownership inclusive of derivatives is of little interest). CEOs with large personal investments in their companies tend to treat shareholders like partners. CEO ownership is also a commentary on how boards have compensated their CEOs in the past and how long CEOs have been investing their careers and capital in their companies.
- We avoid companies that use stock options excessively. We believe CEOs should face the same risk and return profile as shareholders, so stock options are counterproductive. While stock options can be a useful tool to attract management talent in a handful of industries, like early-stage technology and private equity, we agree with Warren Buffett: an option on an established public company is more like "a royalty on the passage of time" than fractional business ownership.
- Share buybacks only create continuing shareholder value if they are conducted at a price below intrinsic value. CEOs are responsible for maximizing long-term shareholder returns by allocating capital between reinvestment, dividends and share buybacks. In this discipline, stock options are also counterproductive because they encourage a myopic focus on the current share price, sometimes at the expense of rational reinvestment and/or dividend payments.
- We prefer companies that reward CEOs with equity investments that pay dividends and participate in the upside and the downside of share price performance. The best way to do this is to hire CEOs who believe in their companies and enthusiastically invest their cash bonuses into company stock. While we prefer share awards to options because they can participate in dividends and share price declines, they lack the "skin in the game" commitment that comes with a good old-fashioned cash purchase of shares.

Notes: Analysis based on trailing three-year averages of available data (2010-12). Dividends include regular and special dividends.
Sources: Capital IQ, Bloomberg, company filings. Market data as of May 1, 2014.

Author: **Andrew Iu, Investment Analyst for Canadian small-cap equities**

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October 2015

Ain't Misbehavin'

Value investing is simple: buy stocks when they are trading for less than their intrinsic value. But simple doesn't mean easy. There are many roadblocks standing in the way of investment success.

There are three pervasive errors that value investors make repeatedly. In this issue of *The View from Burgundy*, we will identify these mistakes and suggest some common causes. We will then develop a framework to help minimize the errors, with help from a new book by economist Richard Thaler as well as observations of Ben Graham and Warren Buffett's respective approaches. Following in the footsteps of these value investing trailblazers should lead to less investor misbehaving.

Pervasive Errors

What are these three errors? The first mistake is failing to buy the shares of a great company as it is swooning, in the hopes of getting it a little cheaper, when instead it rebounds. You end up standing pat and watching it compound its intrinsic value and shareholder return at superior rates for many years into the future. It becomes a huge missed opportunity. Warren Buffett calls these mistakes "errors of omission."

The second error is to successfully make an investment buy, only to fall in love with the company as its stock price gets extended, thus failing to sell when the stock becomes fully valued. You then ride the position all the way back down again. A "round trip." The missed opportunity in this case was an investment sale that never occurred.

The third error is to invest in a "value trap." These are cheap stocks that stay cheap or get cheaper when the company's intrinsic value falls after the investment is made.

Experienced value investing practitioners have made each of these mistakes many times. Finding a way to reduce these three repeated errors is worth money in investors' portfolios. One idea about how to encourage better investor behaviour comes from Richard Thaler's new book, *Misbehaving.*[112]

Thaler wrote *Misbehaving* to memorialize a career helping uncover behavioural economics.

This sub-genre of the dismal science and its related field of study, behavioural finance, arose in the last few decades after the basic assumption underlying economic theory – that people are rational, unemotional and gifted natural statisticians when making choices – proved to be false. Instead, according to Thaler and the other behaviourists, we humans are guilty of systematic and predictable errors by relying on imprecise rules of thumb, anecdotes and stereotypes when making decisions. We are not pure optimizers with perfect information.

Two Types of Utility

Thaler identifies two types of utility. In economics, utility is a term used to measure satisfaction or usefulness. While impossible to measure precisely, utility is what all of us are targeting. For investors, since more wealth equates to more usefulness, better long-term returns generate more utility.

Acquisition Utility

Thaler calls his first type of utility acquisition utility. In economics-speak, it is the amount of satisfaction one gets, minus the price of obtaining that satisfaction. It is similar to the economic concept of consumer surplus, which measures the difference between what a consumer would have paid for a product less the actual price. So if you as a consumer value a product far more than the price paid for it, you will enjoy an abundance of acquisition utility by buying it.

Acquisition Utility	**perceived value > market price**

A "fair" price for a given product is known because it can be seen in the marketplace. A consumer who has long-term expectations for the value of the product exceeding that fair, or market, price can create acquisition utility by purchasing it. Most teenagers who purchase the latest iPhone with their part-time job earnings or allowances can attest to this. Owning a product that you can't live without, no matter the price, makes for a lot of satisfaction.

Transaction Utility

In contrast, consumers do not feel that most products are worth more than the "fair" or typical price they sell for. In the majority of cases, buyers try to pay less than, and only up to, a price level that is deemed "fair." And any time consumers can buy one of these desired products for less than what it normally sells for, satisfaction arises. Thaler calls this second type of satisfaction transaction utility.

Transaction Utility	**purchase price < fair price**

Transaction utility is all about getting a deal. It is generated when you can buy a product for less than its typical fair price. So if you can purchase a tube of toothpaste for $2 that usually sells for $4, you enjoy some transaction utility.

Acquisition and Transaction Utility in Investing

Now let's apply both of Thaler's utilities to investing. Recall that acquisition utility is the satisfaction generated when you value a purchase a lot more than the price it is selling for in the market. With investments, this occurs when investors identify value that they expect will emerge over a long time period as the company grows in monetary worth. Because this value is beyond any obvious statistical measures, it is less visible. Acquisition utility is created with the purchase because buyers expect that long-term returns will be generated as the value of the investment grows over many years.

What about transaction utility? Investors generate some transaction utility on a stock when the price paid makes it a statistical "bargain" purchase. It is a good deal. This bargain can occur if any or all of the price/earnings ratio, price/book value ratio or dividend yield, for example, are at much more attractive levels than typically found for that kind of stock. The satisfaction arises because buyers expect that, given the bargain price, positive investment returns will be earned if the statistical valuation metrics eventually return to more typical levels as the share price moves higher.

While these two types of investment utility are both the result of an expectation of future returns, they are not the same. Transaction utility is all about getting a deal. You go to the store for shampoo and notice dishwasher detergent is on sale, so you buy it too. Your friends and neighbours would probably all agree that it's a deal, and the satisfaction comes from the price discount, not from expectations of future utility.

The same is true with a cheap stock. Not all will have the stomach to catch the falling knife and make the bargain purchase, but most will probably agree that the price is statistically cheap when compared to historical norms. Cheap stocks feel like good deals.

In contrast, acquisition utility is like the satisfaction that comes when you are able to buy a home of the right size and style, in the right neighbourhood, which you plan on enjoying for many, many years. Ten different people would likely have 10 different opinions and levels of utility about the purchase. Some with different tastes and living plans would even feel the home is overpriced. But your mind creates personal acquisition utility, along with a sense of ownership, because you can imagine the long-term satisfaction that will come from inhabiting a great home that perfectly suits your needs for many years.

Investors targeting acquisition utility have the same mindset. Because a great company's attractiveness is harder to prove statistically than the cheap stock discussed above, fewer people will agree that it represents value. But in this case, buyers feel that growth in the investment over time will eventually justify their purchase as a long-term bargain. In economics-speak, they see the present value of the company's future value creation to be high enough above the current share price to warrant purchase.

Each of these utilities comes with different expected sources of return. Transaction utility is all about getting a deal. Investors targeting this type of satisfaction attempt to buy stocks at a big discount to intrinsic value, or with a "margin of safety," as Ben Graham termed it. When the gap between purchase price and intrinsic value closes, positive returns will be earned.

Investors targeting acquisition utility, on the other hand, rely on long-term value growth to generate returns. The size of the current discount is less important, but it is critical that the intrinsic value grows significantly over the long term. The investment value will then grow along with intrinsic value, and positive returns will be generated.

Which Utility to Target?

We have two types of utility to target, each offering a different source of returns. They also offer different risks. To illustrate, let's turn our attention back to the pervasive investment errors.

The first two persistent value investment mistakes occur when investors confuse which utility they are targeting. The first mistake, the error of omission – failing to buy a great company's stock when it is swooning, only to watch it rebound and grow its value for many years thereafter – is made by targeting transaction utility when acquisition utility is more appropriate. Holding out for a huge discount to intrinsic value is counterproductive if the company truly is a great one that will continue to grow intrinsic value over the long term. Being a little less price conscious and buying the stock, to own it, will prove to be the right decision when the stock goes on to grow value for many years.

And the second error, the round trip – failing to sell an investment when it reaches intrinsic value, only to ride it back down again – is made by targeting acquisition utility when transaction utility is the appropriate aim. Again, an investor properly targeting transaction utility should have classified this stock as one bought to be sold when its price is no longer a deal, rather than one to be owned. Because its intrinsic value is not likely to grow at a fast clip for many years, it should be sold when it approaches intrinsic value.

We can reduce the chances of confusing which utility we are targeting by selecting only one type to target. Ben Graham and Warren Buffett did just that.

Ben Graham, the father of value investing and teacher of Warren Buffett, explicitly targeted transaction utility. His approach, which some call "deep value investing," aims to uncover statistically cheap stocks selling for "50 cents on the dollar," buy them, and sell them when they approach his estimate of intrinsic value. By sticking to the sell part of the discipline, he minimized the chances of committing the second pervasive error, the round trip.

Buffett, too, started his career following his teacher's defensible approach. But with the help of eventual partner Charlie Munger, Buffett noticed a persistent challenge. Buying a stock with the intent to sell meant you had to be right three times, not just with the original buy. You also had to be right with the sell decision, as well as the next buy decision as you eventually reinvest the sale proceeds. In Buffett's and Munger's eyes, this meant that there were three chances of making a mistake. So, Buffett evolved.

In the second half of Buffett's career, he evolved to explicitly target acquisition utility. In the vast majority of cases, he now buys stocks (and whole companies) with the intent to own them. Forever. By explicitly targeting acquisition utility, Buffett is less inclined to commit an error of omission – to miss a buying opportunity because he is holding out for a little lower price.

How to Minimize the Three Pervasive Errors

So we have two defensible value investing approaches, each targeting a different type of utility. And we can minimize the risk of investment mistakes caused by confusing which utility we are after if we select only one to target. This is what Ben Graham did and Warren Buffett does. It is the simplest way to frame a value investment approach, and helps to reduce errors made by confusing which utility to target.

But we still need help in determining which investments are suitable for each of these approaches. And some investors would like to maintain the option to target both types of utility, thus increasing their investment flexibility. It turns out that both of these issues can be overcome if we frame the problem by answering two questions.

For each company being considered as a potential investment, ask:

1. Can the company maintain its intrinsic value well into the future? If the research conclusion is that it can, then the company is a potential investment candidate to target transaction utility. Investors must then be patient and wait for enough margin of safety to emerge, thus signaling an appropriate investment opportunity. Price is critical. A deal is what they are after.
2. Can the company instead be expected to grow its intrinsic value at positive rates well into the future? This is a much higher bar to hurdle, as these types of long-term growth companies are rare. The business must have a secure and persistent base of profitability along with a long runway of profitable reinvestment opportunities. If research uncovers a candidate, investors can then wait for a buying opportunity to target acquisition utility. They can be less price conscious with these investments, but must be sure about the long-term value growth.

All other companies that don't meet either of these two screens (the far larger data set) must be discarded as potential investment opportunities. The insistence on only investing in companies that can at least maintain intrinsic value will reduce the chances of falling into value traps – investing in cheap stocks that remain cheap or get cheaper because their intrinsic value falls after investment. Framing the investment problem this way aids in minimizing that third pervasive value investing error.

A Framework to Minimize Mistakes

We identified three pervasive value investing errors – the error of omission, the round trip and the value trap. We then used Richard Thaler's classification of two types of utility to develop a framework to help minimize these mistakes:

1. Classify all prospective investments by determining which companies can at least maintain intrinsic value. By eliminating all others from being potential investment opportunities, the probability of investing in value traps is reduced. The resultant companies are suitable as potential targets for those targeting transaction utility when the discount from intrinsic value is large enough.
2. Companies that can clear a far higher bar, that have a near certain likelihood of significantly growing their long-term intrinsic value, are suitable as potential investments for those targeting acquisition utility. While investors can be less price conscious when making investment

purchases with these companies, extreme care must be taken when coming to the conclusion about positive long-term value growth.

3. Having decided which of transaction or acquisition utility will be primarily targeted, monitor the portfolio companies. When the risk of a company having a different intrinsic value outlook than was originally determined has increased, action should be taken. If those companies that investors originally determined would maintain intrinsic value now look to be at risk of not doing so, the investment should be sold. The same is true for those companies they felt would generate long-term value growth when it no longer looks to be the case. This will prevent value traps from emerging within a portfolio.

Conclusion

Long-term investors are targeting more usefulness, or satisfaction, in their quest for better long-term returns. Economists call this satisfaction utility. Richard Thaler's identification of two types of utility – acquisition utility and transaction utility – allows us to develop a framework to help minimize the three pervasive errors value investors make. With this framework, some patience and a long time horizon, here's hoping we see fewer errors of omission, round trips and value traps – in short, less investor misbehaving – and a lot more portfolio satisfaction.

Author: **David Vanderwood, Senior Vice President and Portfolio Manager for Canadian equities**

December 2015

Not the Time to Sell

Suncor Energy Inc. (Suncor) announced a hostile offer to buy all of the outstanding shares of Canadian Oil Sands Limited (COS) on October 5, 2015. As the owner on behalf of our clients of COS shares, Burgundy will not accept the original Suncor offer. In this issue of The View from Burgundy, *we outline why. In short, COS owns a stake in a unique and extremely valuable long-term asset, a scarce resource that is almost impossible to replicate. And the price Suncor is offering, representing one-half of what it would cost to recreate this asset (if it was possible), is unacceptable.*

[Update: on January 18, 2016, Suncor increased the offer by 12%, paying us in high-quality and depressed Suncor shares. We tendered our shares to the new, higher offer.]

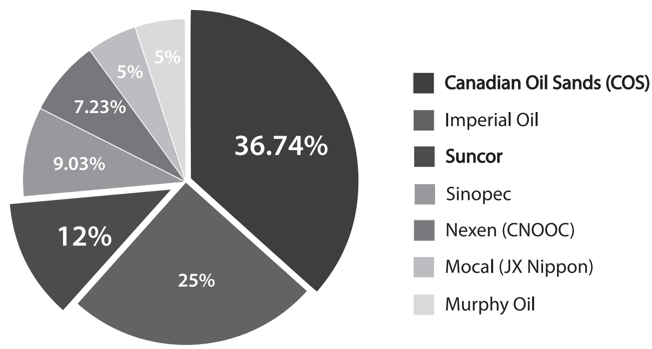
The Battle for Syncrude

COS is a pure play "upstream" oil production company. It owns 37% of the Syncrude Canada Ltd. (Syncrude) joint venture, an oil sands mining operation near Fort McMurray, Alberta (see Figure 1). Suncor is the largest oil company in Canada and owns a 12% stake of the Syncrude joint venture. Besides producing oil mainly in Alberta's oil sands, Suncor also has a large "downstream" business that processes the raw material into useable products and sells them to end users. This business unit operates in a very profitable oligopoly in Canada and is rewarded for scale economics. It is also benefiting from a glut of Canadian oil production that lacks sufficient pipeline takeaway capacity. This depresses its local raw material costs and allows it to earn fat margins on end products like gasoline that sell at higher prices based off of global benchmarks. As such, it is generating substantial profits, even in this depressed oil price environment.

Suncor acquired its stake in Syncrude through its 2009 acquisition of Petro-Canada. That deal worked out brilliantly for Suncor, coming as it did at the bottom of an earlier oil price cycle. Besides the Syncrude stake, the Petro-Canada purchase brought Suncor most of its downstream refining assets, whose profitability is allowing the company to ride out this current period of weak oil prices. To its credit, Suncor is trying to recreate this magic with the counter-cyclical COS offer.

FIGURE 1

SYNCRUDE OWNERSHIP



Source: Canadian Oil Sands Ltd. UBS –
Energy 1x1 Conference, November 23, 2015.

Both COS and Suncor can trace their respective histories back to the two original oil sands mines in Alberta: Great Canadian Oil Sands and Syncrude. Suncor emerged from the Great Canadian Oil Sands consortium, which began production in 1967, while Syncrude started operating 11 years later. Both operations produce bitumen, or oil that is too heavy to flow on its own, which is extracted from oil-soaked sands located at the earth's surface using shovels and trucks. This "heavy oil" is then processed and upgraded into light oil that refiners prize because it can be converted into very valuable end products like diesel, jet fuel and gasoline.

A Valuable Asset

Oil sands mines are attractive assets for several reasons. First, once built, they produce oil at steady rates for many decades. This stable production makes these assets very valuable. In contrast, conventional oil wells see their production rates steadily decline. Conventional producers are on a treadmill where they must continually discover or acquire and then develop new sources of production.

Canada's oil sands mines also contain huge reserves in a world where non-government oil companies are increasingly challenged to own resources. It is estimated that more than 85% of the world's oil and gas reserves are held by government-owned national companies like Saudi Aramco. As such, the ability for private sector companies to control billions of barrels of reserves and decades of future production is a valuable commodity.

In addition, many oil reservoirs are located in politically risky areas like Venezuela, Nigeria and the Middle East. Again, getting access to huge proven reserves in a safe political locale for shareholders is valuable.

Fewer Risks

The billions of barrels of reserves that oil sands mines control in a safe political locale means they have far less operating risks to manage. Importantly, oil sands mines have no reserve risks. Conventional oil properties can perform less than expected – they can "water out" or fall prey to other geologic risks. This exposes their owners to potentially large losses and wasted investment spending. With the oil sands mines, the reserves are there.

And oil sands mines have no exploration risk. Conventional oil companies that are on the treadmill caused by ongoing well declines must constantly replace their produced reserves via exploration or the acquisition of someone else's discovered reserves. Unlike the reserves at the oil sands mines, there are no guarantees that future exploration will be successful.

Lastly, once built, the oil sands mines are subject to limited capital spending risk. While intermittent projects to move equipment away from produced areas to undepleted zones must be undertaken, by their nature the oil sands mines do not face the consistent investment risks that conventional companies do as they continually attempt to replace their produced reserves. Again, there are no guarantees that conventional reserves can be replaced in a cost-effective manner.

A Scarce Asset

In economics, scarcity helps determine value. It is why diamonds, a non-vital commodity to most, are so much more valuable than water, which is a necessity for life. A high value is realized because diamonds are rare. Oil sands mines are rare too.

Alberta's oil sands are unique on a global scale. Oil sands production only accounts for 5% of global oil production. Only Venezuela has similarly sized deposits, but high political risk has led to minimal development. These are indeed scarce assets.

In addition, most of Alberta's oil sands are too deep to mine. Of the 140,000 square kilometres of oil sands, more than 135,000 are located far too deep where expensive steam must be injected to allow the oil to flow to surface. That is why there is only a half-dozen oil sands mines in Canada where the oil-soaked sand deposits are shallow enough to economically mine. So an ownership stake in a rare surface deposit like Syncrude's is a scarce asset.

A Pure Play

A "pure play" is an investment security that is made up of a single type of asset. In finance theory, because investors can optimize their own portfolios by selecting a collection of individual investments according to their unique risk tolerances and goals, pure plays are especially attractive. Pure plays typically trade for higher valuations as stand-alone securities, rather than when the assets are hidden inside conglomerates where a diverse collection of assets typically trades at a large "conglomerate discount."

COS's share of the Syncrude oil sands mine is its only asset. Moreover, all the other oil sands mines are owned inside large, multinational oil companies that have many assets. COS is thus the only way for investors to gain "pure play" exposure to oil sands mining, itself a scarce resource. While this uniqueness may not be worth much at the bottom of the oil price cycle, it can have very positive effects on valuation in stronger oil price environments, as we shall see.

Huge Exposure to the Price of Oil

Oil sands mines are fixed-cost businesses. Once a mine is operating and incurring expenses, it costs almost nothing extra to produce an incremental barrel of oil. So the mines produce what they can, regardless of the price of oil.

Operating costs to run a mine are higher than for many other types of oil production. So at the current depressed levels of oil prices, COS is not generating a lot of cash flow. But as with any fixed-cost asset, a very large percentage of every dollar increase in the oil price is profit. As such, COS has tremendous exposure to the commodity price. Historically, the correlation between the oil price and the COS share price has been about 98%.

Many investors also fail to appreciate that operating costs are not the only cost to consider when evaluating oil projects and companies. The profitability of an oil project is determined by both operating and investment costs. Many projects have lower operating costs per barrel than the oil sands mines, but once investment costs are factored in, and especially the lack of future investment needed to replace production as is required at conventional projects, oil sands mines earn competitive returns on investment at most points in the oil price cycle. That is why Suncor is plowing ahead with another oil sands mine, Fort Hills, as we write.

Let us illustrate how low investment spending helps COS ride out periods of low oil prices. COS management is forecasting C$338 million in free cash flow, after investment spending, in 2016, or C$0.70 per share, if the standard WTI oil price averages only US$50 per barrel. The limited investment spending required at a built oil sands mine like Syncrude allows for cash flow generation and flat production volumes in weak pricing environments. We struggle to identify other upstream oil companies that are expected to generate both flat production volumes and free cash flow at similar depressed oil prices. The quality of COS and its Syncrude asset really stands out.

As we have seen, once the mines are built, as in the case of Syncrude, future investment spending is limited, which enables positive project cash flow at almost all oil price levels. Since 2001, COS has distributed C$7.9 billion, or C$17 per share, to shareholders during a period when the oil price averaged US$65 per barrel. Moreover, valuation multiples for a scarce resource pure play like COS can stretch well above replacement values, as we shall see.

Private Market Value

One method to evaluate value is to look at prior transactions and estimate so-called "private market value." This is the valuation that an asset traded hands for in the private market.

Ownership positions of the Syncrude joint venture have changed hands in the recent past, including when Suncor acquired Petro-Canada in 2009 and when Chinese-controlled CNOOC Limited acquired Nexen Inc., which owns 7% of Syncrude, in 2013. The most recent deal for a pure play was in 2010 when Sinopec Group (Sinopec), another Chinese company, bought ConocoPhillips' 9% stake for US$4.65 billion.

For this recent pure play transaction, it is useful to determine what the multiple per percentage ownership of Syncrude equates to in terms of a COS share price. To be conservative, we assume Sinopec paid the same amount, but in Canadian dollars (since the Canadian dollar and the price of oil tend to move in lockstep, and both were significantly higher in 2010). When adjusted for the current level of COS debt, the value Sinopec paid equates to C$34 per COS share, which is more than three times the value of the Suncor offer. This private market value example is an illustration of the upside potential of a scarce resource asset in a stronger part of the oil price cycle.

Because the valuation of commodity stocks is tied to where we are in the inevitable price cycle, some investors attempt to buy these cyclical stocks at the low end of the price cycle, and sell them at the high end, by guessing where we are in the cycle. This is tougher than it looks because cycles can last longer – and end quicker – than most predict. Rather than try to guess when the bottom is, based on investor sentiment, replacement cost analysis is more defensible.

Replacement Value Is a Useful Valuation Tool

Replacement cost analysis is another way to evaluate value. Besides the current Fort Hills project, many of the mines have been expanding, including Exxon Mobil Corporation and Imperial Oil Limited's Kearl project and Horizon owned by Canadian Natural Resources Limited. It is significant that these savvy long-term owners must have a positive long-term view on the economics of their mines.

The investment cost of the recent and current projects allows for an estimation of replacement value, or what it would theoretically cost to build a project that replicated Syncrude. This is theoretical because none of the land appropriate for mining projects is available. It was tied up by savvy companies many years ago.

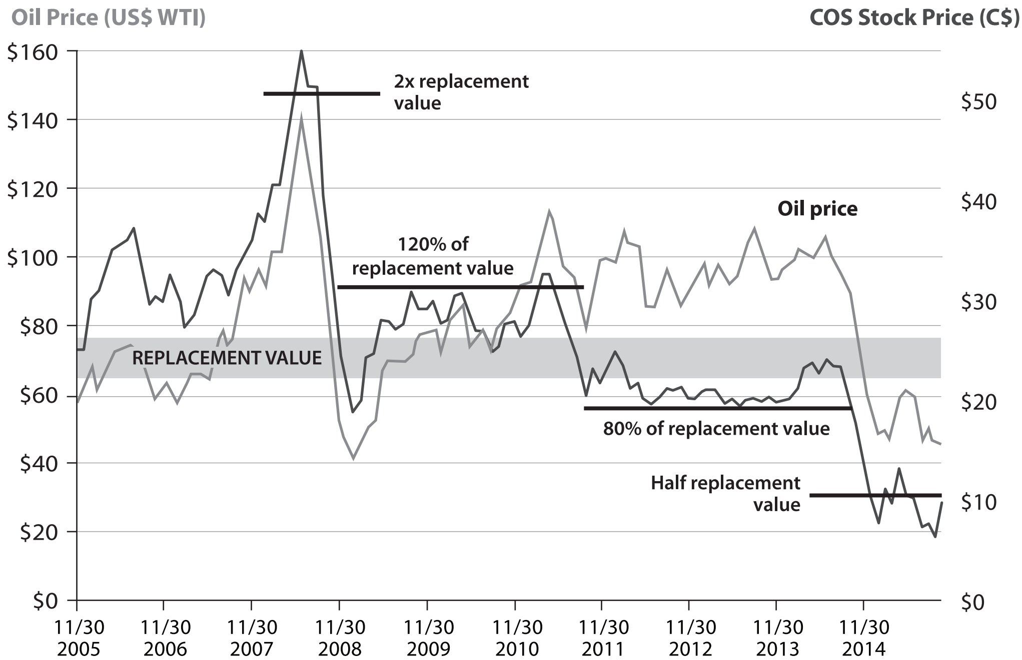
While replacement cost can be pro-cyclical – it rises during boom times because of inflationary pressure, and falls during industry lulls – mining investment costs haven't experienced any step changes in the past several years. So it can be a useful measure if applied with conservatism.

It is also noteworthy that the recent new builds have not included an upgrader, which processes the lower quality heavy oil into higher valued light oil. While this makes for cheaper projects, it exposes the new mines to the volatility of heavy oil prices, which is far greater than that for light oil. Syncrude has an upgrader, and as such is not exposed to these heavy oil price swings.

In addition, Syncrude's upgrader allows it to realize oil prices that are far higher than that earned by heavy oil producers. COS has typically received 40% to 55% greater prices for its upgraded light oil than those earned by the non-upgraded mines. This highlights the hidden value of its upgrader. Indeed, COS estimates that 75% of its free cash flow from 2009 has come from its upgrader.

Figure 2

CANADIAN OIL SANDS TRADING PRICE, REPLACEMENT VALUE AND THE PRICE OF OIL



Sources: Bloomberg and Burgundy research

As Figure 2 outlines, the market has been very rational in its valuation of COS's pure play stake in the project. We estimate that over the past five years, with oil generally trading at levels approximating the marginal cost of production, which most analysts would suggest is the best predictor of long-term oil prices, COS traded between 80% and 120% of replacement value. It makes sense in a stable and reasonable market for an asset to trade at what it would cost to replicate it. Of course, it is important to remember that, given the lack of available oil sands mining resources, Syncrude cannot be replicated.

We also note that in the very strong oil price environment of 2007 and early 2008, COS traded at more than twice replacement value. In the recent weak oil price environment of 2015, including the valuation that the Suncor offer is putting on COS, it has traded at about one-half of replacement value.

This suggests that selling at this current depressed level only makes sense if one believes that oil prices will not recover. This seems highly unlikely.

The Price of Oil Will Recover

The oil price will rebound because commodity prices are self-correcting. While no one can predict when, higher oil prices are as near a certainty as we get in the investment business.

Why are price cycles inevitable? Commodity prices cycle around their respective industry's marginal cost of production – the commodity price needed to justify developing the next so-called marginal or incremental project – because both supply and demand respond to price.

When prices are high, new projects are started and conservation kicks in. This eventually overwhelms the excess demand and causes prices to drop. And when prices are low, high cost production is shut in, new projects are cancelled and demand picks up. And in the case of oil where most non-oil-sands projects see declining production, natural declines set in. These forces eventually work off the excess supply, allowing prices to rise.

COS Can Ride Out the Weak Prices

Along with a strong balance sheet, no debt maturities until 2019 and debt covenants tied to its substantial asset value (not cash flow), COS is well positioned to ride out the current period of low oil prices. And when prices recover, given its fixed costs, cash flows and the share price will recover even more. And remember the 98% correlation between COS and the price of oil? This will work wonders for investors in an improving price environment. COS will be a revenant.

Short-term Wise Is Long-term Foolish

Yes, if the Suncor offer fails and another, superior one fails to emerge, the COS share price may drop in the short term. But that is a small price to pay for maintaining ownership of a pure play, scarce, long-term resource that will trade at much higher levels than the Suncor offer when oil prices recover. Investing is a marathon, not a sprint.

We Are Not Selling

Burgundy is not tendering to the original Suncor offer. Both its timing and, more importantly, its valuation are contrary to the long-term interests of COS shareholders. As oil prices recover to levels consistent with the marginal cost of production (US$75 to US$80 per barrel) over the next several years, COS's valuation should once again approach replacement value. As this level is double that of the recent Suncor hostile offer, we are turning it down. Giving up unique, irreplaceable and low-risk exposure to the price of light oil today, when oil prices are in a trough, is the exact opposite of what long-term investors should be doing.

Author: **David Vanderwood, Senior Vice President and Portfolio Manager for Canadian equities**

June 2016

Boots on the Ground: The Essential Role of Travel in our Global Investment Approach

Travel plays an essential role in Burgundy's bottom-up investment research process. Our portfolio managers and analysts regularly travel to find new investment ideas, conduct due diligence on portfolio holdings and build expertise on the geographies where our investments reside. As a global investor based in Toronto, this is particularly important to us – in 2015, our Investment Team held more than 850 meetings with companies in at least 17 countries across North America, South America, Europe and Asia.

We recognize that it may not be entirely self-evident how travel contributes to Burgundy's end goals of protecting and growing your capital. In this issue of The View from Burgundy, *we attempt to describe the types of valuable first-hand experiences that travel delivers, all of which contribute meaningfully to our investment process – and your portfolios.*

This issue of The View from Burgundy *was written by Jeff Musial, Investment Analyst for Asian equities. Most of the examples throughout are drawn from the Asian equity team's experiences, but conversations with any of our Investment Team members will demonstrate they all have similar stories to tell.*

> "Pure logical thinking cannot yield us any knowledge of the empirical world; all knowledge of reality starts from experience and ends in it."
>
> *Albert Einstein*

As investment analysts, we are constantly striving to grow our knowledge of businesses by learning from a multitude of sources. These include company filings, phone discussions with management teams, conference call transcripts and industry publications, all of which are invaluable and necessary in helping us build our understanding of specific companies and industries. However, there is no substitute for physical travel to another location or country to see managers, businesses and economic environments first-hand. Company visits add depth and a crucial element of context to the research process.

The insights gained from on-the-ground experience are many, and in this issue of *The View from Burgundy* we will describe them across five dimensions: first impressions, face-to-face interviews with management, site tours, knowing the lay of the land and cultural understanding. Altogether, these are the key ways in which we are able to improve our understanding of businesses and their environments when we travel.

First Impressions Matter

The primary purpose of our research trips is always to meet managers in person, with a typical trip consisting of 25 to 30 meetings in a single week. Time is frequently in short supply as we drive from one corporate headquarters to the next, conducting intense interviews with senior managers. On trips outside of North America, both language barriers and jet lag add elements of complexity. But despite the challenges, we find these trips to be instrumental in helping us conduct due diligence and build our knowledge of companies.

There is much to be learned before a meeting even begins. Take, for example, a recent experience in Australia, where we met the management of a large international commodity producer. Standing in the office lobby, we marvelled at our surroundings: gleaming white marble walls, lofty ceilings and an impressive 20-foot-tall black door that automatically (and silently) slid to one side to grant us entry. The environment inside was equally lavish, with lush leather seats, expensive art and even a well-stocked employee bar! While by no means a conclusive analysis, simple observation left the impression that this was not an overly cost-conscious company. Now compare this experience with a more recent one we had in Japan, where we visited a highly successful, rapidly growing and profitable e-commerce firm. Despite having the means to provide similarly luxurious facilities for its employees, we met the company in its modest head office located above a supermarket. Imagine the contrasting impression this left upon us with regards to how each company views its overhead expenses and shareholders in general.

Q&A with Management

Our investment research approach at Burgundy is bottom-up in nature, which means that we make investment decisions based on our understanding of individual businesses and their competitive environments. What we look for are companies that possess quality characteristics, such as high returns on capital, opportunities for growth, strong competitive positioning and excellent management – and when assessing this latter point, face-to-face meetings with managers are indispensable.

Meeting with a company's senior management in person provides us with a forum for asking questions and airing concerns, and also provides a more thorough understanding of how they run the company. Questions we ask have to do with topics such as capital allocation, competitive dynamics, industry trends and corporate governance, to name a few.

When listening to a management team's responses, we are first and foremost trying to learn. But we also pay close attention to what their answers say about how they think about the business, such as whether they take a short-term or long-term approach to growing profits and building a competitive advantage, or whether they tend to think conservatively about the business. On this point, what is not said is sometimes just as important as what is. For instance, in Japan we occasionally encounter management teams who, across multiple meetings, will never utter the phrases "return on equity" or "shareholder returns." What they aren't saying demonstrates that they do not think about their businesses in a way that emphasizes capital efficiency, which is a knock against them in our quality-value investing playbook.

Site Tours (a.k.a. "Kicking the Tires")

Management meetings are not the only on-the-ground tool we use in our efforts to learn more about a business. Another piece of proper due diligence is conducting site tours, in which we visit factories, distribution warehouses, and research and development (R&D) centres in order to flesh out our understanding of how a company works – "kicking the tires," so to speak. This is often one of the most illuminating parts of the learning process while we are getting to know a business.

Site tours greatly enhance our ability to understand companies; in the same way that a picture is worth a thousand words, a site tour can sometimes be worth weeks of research done sitting at one's desk. Simply put, seeing a business or process in action can clarify and add detail to what may be difficult to understand through written sources alone. Many of our "aha" moments occur on site tours, as what was previously confusing becomes clear.

The insights from a site tour can vary, ranging from an enhanced understanding of a business on one end to disturbing red flags on the other. On this latter point, consider a site tour the Asian equity team conducted years ago at a Chinese flavour and fragrance company's R&D facility. Normally lab environments are tightly controlled, but in this case, rooms labelled "temperature controlled" had open windows, letting in both the hot summer air and a fair share of local insects. What's more, the facility was curiously devoid of employees, and the few research staff we did encounter were surly and unapproachable. It seemed odd to us that a company could have its main

R&D facility in such a state of inactivity and disrepair, while reporting seemingly world-leading profitability in a highly competitive research-driven industry. Our negative impression from the site tour provided useful information that would have been difficult, if not impossible, to acquire had we not done the on-the-ground work. It prevented us from making an investment in what had appeared on paper to be an attractive business, provided one didn't scrutinize its operations – an example of why relying on company-produced financial statements alone is not sufficient when conducting due diligence.

Site tours can inform us not just on the business itself, but also on the other companies that make up its value chain. On a recent site tour at a high-end consumer goods manufacturer (and Burgundy holding) in Japan, close inspection revealed that some of the factory automation equipment used in its production line was made by another holding of ours. This allowed us to learn more about the production process, while also hearing invaluable first-hand views about the quality and competitiveness of the automation supplier's equipment.

Knowing the Lay of the Land

While travel is invaluable in growing our understanding of businesses, it also gives us a much clearer perspective about the environments in which they operate and compete. As investors in companies located across the world, from Chile to Belgium to China, it is absolutely essential that we understand the countries in which we do business, and first-hand experience is an essential component.

Our time spent in foreign countries is always a rich learning experience, even outside of the meeting room or factory. Take, for instance, the phenomenon that is the Japanese convenience store. To someone who has never been to Japan, it can be difficult to understand why 7-Eleven is a thriving business and a leading international example of retailing excellence; written sources do not do it justice. However, even a couple brief visits to a Tokyo 7-Eleven (and a few of their lunch boxes) help make clear that it is a local institution visited not just for packaged candy and drinks, but also for fresh food, airline tickets and day-to-day banking services – all of which drive return visits and enhanced profitability.

Even our more casual observations can add colour to the investment research process. For instance, compare the knowledge gained from reading statistics about the Chinese consumer's increasing attraction to Japanese products against our experience of actually being jostled by seas of Chinese shoppers in Tokyo's famous Ginza district. Indeed, experiences that are sometimes uncomfortable or frustrating in the moment can be illuminating upon later reflection.

Our on-the-ground experiences can even occasionally be extreme or dangerous in nature, but no less informative. In March 2011, Burgundy's Asian equity team was in Tokyo during Japan's devastating earthquake and nuclear disaster. This provided lessons for local businesses as to the need for disaster preparedness and a flexible supply chain that can recover quickly from such an event, and was a particularly stark lesson for investors about the unlikely but dangerous risks posed to people and businesses in regions prone to natural disasters. What's more, the experience provided a humbling reminder of how truly unpredictable the future often proves to be, which as investors we can only address by being conservative in our forecasts and by demanding a significant margin of safety in our investments. Lastly, it was a reminder of the resilience and courage of the Japanese people, when many had forgotten how much that matters.

These on-the-ground environmental insights add to our knowledge of business conditions in different countries. The way we see it, the more context investors have concerning their market of focus, the better – it is not a coincidence that each member of our Asian equity team has Japanese or Chinese language skills and has lived in the region for multiple years.

Cultural Understanding

Local culture is not to be overlooked in understanding the countries where we invest because it can help provide insights into behaviour, both on the individual and organizational levels. A good example is the 2011 scandal at Japan's Olympus Corporation, in which the company had hidden more than US$1.5 billion of investment losses during the tenures of two company CEOs. This stemmed from a deeply rooted practice in the firm of not questioning senior executives, common in Japan's highly hierarchical work culture. Or, conversely, consider Japan's rapid recovery from its disastrous 2011 earthquake, which was only achievable through widespread co-operation among the state, businesses and individuals for the betterment of Japanese society – reflecting a cultural focus on placing society above self.

Cultural knowledge can play a meaningful role when investing in certain countries, and experienced investors with a stronger understanding of local culture are better able to navigate the resulting idiosyncrasies. For example, it is important to recognize that Japanese societal values are collectivist in nature, focused on producing positive outcomes for all stakeholders. This affects us as investors on a regular basis, because it often means that businesses place clients, employees and society as a whole above the interests of shareholders. As a result, many Japanese companies are corporate citizens dedicated to creating a valuable product or experience for their customers, but who are also insufficiently aware of corporate governance issues. Our role is not to judge or expect rapid change in these values, but rather to understand them, communicate our views with management and work towards better investment outcomes.

Conclusion

As investment professionals, the nature of our work is such that we spend a great deal of time reading and thinking. However, we must remember that all useful knowledge is not confined to an annual report. Travelling abroad is an essential element of our investment process because it gives us the opportunity to better understand companies and their environments from an on-the-ground perspective. The unique insights we can gain from these experiences bring our research to life and make us more informed global investors.

Author: **Jeff Musial, Investment Analyst for Asian equities**

October 2016

Winning by Not Losing

Anne-Mette de Place Filippini, Senior Vice President and Portfolio Manager for Emerging Markets equities, delivered the following presentation at the London Value Investor Conference on May 26, 2016.

Before I became an investor, I was a tennis player. I played competitively as a junior and became pretty good at the game. It took me a long time to learn the lesson that, many more times than not, winning is the result of not losing. Neither striking great shots nor having a better game is a prerequisite to winning; making your opponent hit another shot is what really matters!

Wimbledon is the most prestigious Grand Slam tournament in tennis. I thought it would be fitting to illustrate this point by looking at what became known as one of the best matches ever played: the 2008 Wimbledon final between Roger Federer and Rafael Nadal.

Federer had already won the Wimbledon title five consecutive times, from 2003 to 2007, and was a favourite going into the match. In both 2006 and 2007, the two had played epic finals at Wimbledon and their rivalry had become legendary.

After the winner lifted the trophy at 9:20 p.m., there was a 1,400 megawatt spike in the U.K. national power grid, equivalent to half a million tea kettles being boiled at the same time. Fans had been glued to their seats and caused an enormous surge when they all got up after the game to turn on the lights. John McEnroe put it best when he said, "Well, there's nothing left to say here… Simply the greatest match I ever saw in my lifetime." [113]

Looking at the match statistics (see Figure 1 on the following page) can help us understand why this was such an epic match.

Roger Federer played a terrific match. He served more aces, hit a faster serve, played more aggressively by going to the net more often and hit 50 per cent more winners than his opponent. On most metrics, he did better or at least as well as his opponent. A +37 differential between winners and unforced errors is rare and spectacular, not something you see often.

So why did Federer **lose**? Rafael Nadal played better on one key metric: **unforced errors**. An unforced error is when you lose a point by hitting the ball into the net or hitting it out of bounds without being under duress from your opponent. In other words, you missed a ball you shouldn't have missed. Nadal hit only 27 unforced errors against Federer's 52. Even though he was outplayed on winners, Nadal won because he played more within himself, within his comfort zone. He didn't play as aggressively and didn't hit as hard, but won by making fewer errors. On a subtler metric, break point conversions, we can also see that his mental energy was well directed, winning the right points and converting more opportunities into games.

Now the catch is that "winning by not losing" is not nearly as appealing to our psyche as a "winning by winning" strategy. It just feels a lot better to win by hitting great shots, or in investing terms, to pick stocks that turn into multi-baggers. Telling the story, "I won because I played some amazing shots, hitting my favourite forehand winner," is much more appealing than the alternative, "I won because I played with a margin of safety that allowed me to make few mistakes." But if we go with the appealing strategy, we may find ourselves, as Federer did, making more unforced errors.

FIGURE 1

WIMBLEDON FINAL 2008

Roger Federer		Rafael Nadal
65%	**1st Serve %**	73%
25	**Aces**	6
2	**Double Faults**	3
89	**Winners**	60
52	**Unforced Errors**	27
+37	**Winner – UFE**	+33
73%	**Winning % on 1st Serve**	69%
57%	**Winning % on 2nd Serve**	59%
33%	**Receiving Points Won**	33%
1/13 (7%)	**Break Point Conversions**	4/13 (30%)
42/75 (56%)	**Net Approaches Won**	22/31 (71%)
129 mph	**Fastest Serve**	126 mph
117 mph	**Avg. 1st Serve Speed**	112 mph
100 mph	**Avg. 2nd Serve Speed**	93 mph

Data source: Wikipedia "2008 Wimbledon Championships – Men's singles final"

Unforced Errors in Investing

So what are the common unforced errors in investing?

Unforced Error #1: Chasing Winners

It is much more exciting to tell a story about hitting great winners than simply getting the ball back in the court, and nowhere in investing is storytelling more prevalent than in emerging markets. Great narratives get spun that capture the imagination of emerging market investors. Rewind a few years and the story on Brazil went something like this:

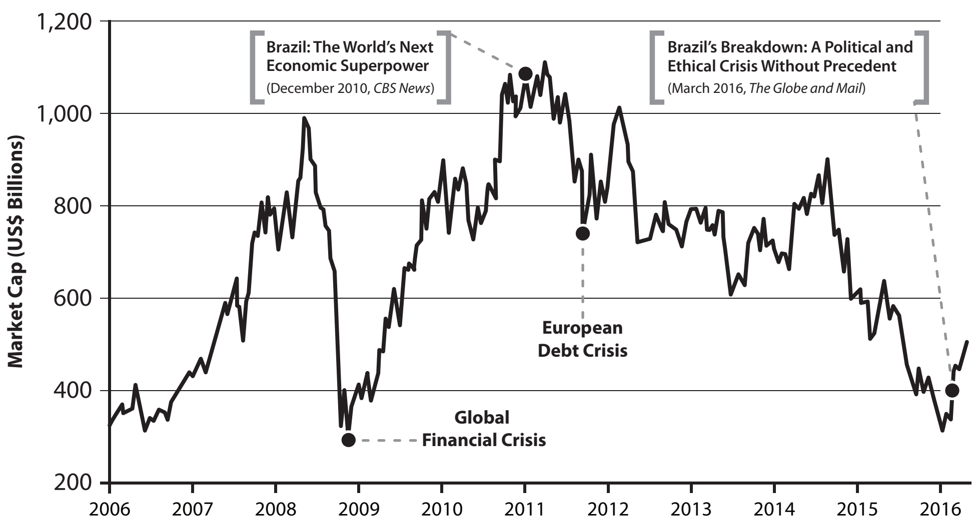
> *China's torrid growth requires ever larger tonnage of raw materials from Brazil. Massive new oil discoveries will permanently alter the country's terms of trade. This will spur an investment boom and require substantial new infrastructure to be built. Oil sector privatizations will open the gates for private capital and entrepreneurs to prosper.*

At the height of the stronger-for-longer commodity boom, it was standing-room-only when the CEO of the Brazilian mining giant Vale hosted an investor luncheon in Toronto. The Global Financial Crisis inflicted severe pain in 2008-09, but the market recovered swiftly on "decoupling" and stimulus, and in late 2010 hit new highs (see Figure 2). At an event hosted by *The Economist* in Mexico around this time, the audience was asked to cast a vote on, "Is God Brazilian?"

Figure 2

CHASING WINNERS

Brazil's Bovespa Index



Source: Bloomberg

Inevitably the boom turned to bust. Growth faltered and went into reverse on exceptionally poor policies, and the economy slid into the worst rot in living memory. The unveiling of staggering corruption took the country from an economic to a political crisis, which is where we are today. In January 2016, the market revisited 2008 lows, valuing Brazil's Bovespa Index at only a little more than US$300 billion, 70% below its highs. In other words, the entire Brazilian market was being valued at just over half of Apple's total market capitalization.

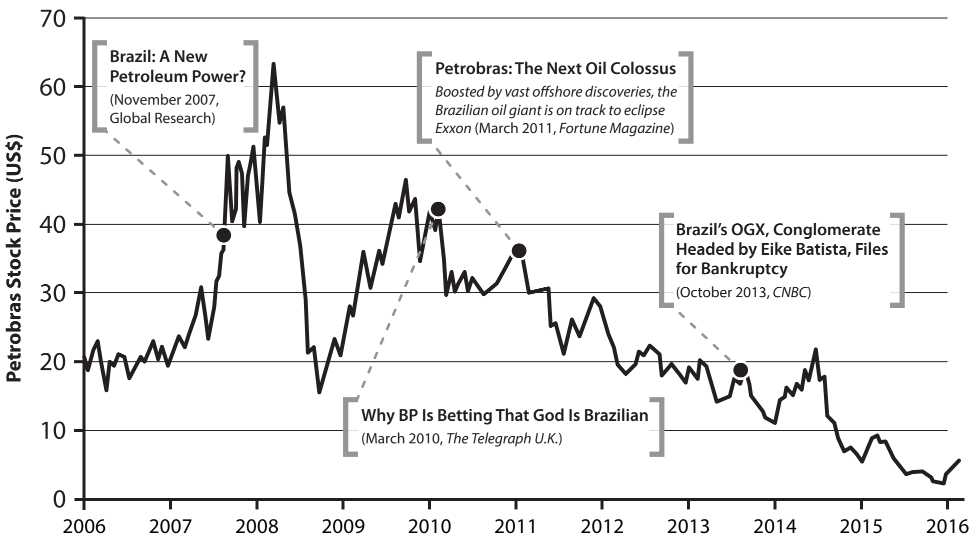
The perceived biggest winner, the oil industry, ended up being the biggest unforced error (see Figure 3). From the peak in 2010, investors lost 90% of their money in Petrobras stock when measured in U.S. dollars. From peak to trough, US$220 billion dollars vanished in Petrobras stock and another US$80 billion dollars in Eike Batista's oil and gas business, OGX. Not to mention the US$330 billion dollars spent in Petrobras' capital budget over the past 10 years – it is difficult to determine future returns on those capital expenditure dollars.

In May 2016, Petrobras named Pedro Parente as the company's new CEO; he is an experienced leader dating back to the Cardoso administration and I suspect his reign will bring important improvements to the company.

Nevertheless, Petrobras remains a government-run and -controlled company, and serves as a stark reminder of the perils of investing alongside government. Governments are not attractive business partners for minority investors. There are many government

FIGURE 3

BRAZIL OIL BOOM & BUST



Source: Bloomberg

businesses listed on emerging markets exchanges. We find them especially in sectors considered strategic by the state: oil and gas, and financials. The problem for minority investors, like us, is that they are managed to achieve a broad array of priorities. They serve many objectives: social, political, power and security. They are run for the good of the state and rarely on sound business principles.

Unforced Error #2: Not Knowing What You Are Doing

If hitting winners is hard, a tennis player might revert to a strategy of trying to do everything well by covering lots of ground. In investing, this would be equivalent to diversifying and, at its extreme, indexing or buying the market as a whole. In emerging markets, we believe that is a particularly bad idea because it exposes your investments to risks you did not intend to assume.

Figure 4 shows the top 30 constituents in the MSCI Emerging Markets Index. Three-quarters of the companies here are either global in nature, government-controlled or in anomalous structures, such as Variable Interest Entities (VIEs), to get around foreign ownership restrictions. This is not an exciting list for quality investors looking to invest in emerging markets.

Figure 4

DOWNSIDE TO BEING EVERYWHERE

MSCI Emerging Markets Index – Top 30 Index Members

Samsung Electronics	3.83%	Bank of China	0.89%	**CNOOC**	0.61%
Taiwan Semiconductor Manufacturing	3.14%	**Gazprom**	0.84%	**Lukoil Holdings**	0.59%
Tencent Holdings	2.90%	Itau Unibanco Holding	0.79%	Sberbank Russia	0.57%
China Mobile	1.93%	Banco Bradesco	0.76%	**Hyundai Motor**	0.53%
Naspers	1.51%	Ambev	0.73%	**Reliance Industries**	0.53%
China Construction Bank	1.48%	*Baidu*	0.72%	**China Petroleum & Chemical**	0.50%
Ind. & Commercial Bank of China	1.10%	Ping An Insurance	0.68%	**Sasol**	0.50%
Alibaba Group Holding	1.04%	Housing Development Finance	0.67%	**Steinhoff International Holdings**	0.50%
Hon Hai Precision Industry	0.94%	Petroleo Brasileiro	0.63%	**Tata Consultancy Services**	0.50%
Infosys	0.92%	America Movil	0.61%	MTN Group	0.48%

Company is: **BOLD** = Global; UNDERLINE = Government Controlled; *ITALICS* = Variable Interest Entity (VIE)

As at April 30, 2016.
Source: MSCI

Unforced Error #3: Overpaying

In tennis, this would mean hitting too close to the net or picking a target on the line – two strategies that leave no margin of safety. At Burgundy, we are value investors with a bent for quality, and the challenge we face today is that obvious quality is very expensive. Here are some of the highest-quality companies that we have found in Southeast Asia.

GREAT COMPANIES DON'T ALWAYS MAKE GREAT INVESTMENTS

	Trailing P/E Multiple	Forward P/E Multiple
Hindustan Unilever	44x	38x
Unilever Indonesia	58x	54x
HM Sampoerna	43x	39x
Asian Paints	56x	46x
Nestlé India	50x	45x
Bumrungrad Hospital	43x	38x
Average	**49x**	**43x**

Source: Bloomberg

Investors are paying, on average, 49 times trailing earnings and 43 times the current year's forecasted earnings. A lot of growth is built into those valuations. They trade at a large valuation differential to their developed market peers.

As you can see in the table below, we would need 14% to 20% compound earnings growth over the next five years to close this gap. If we add a hurdle rate for deploying capital of 10% per year, then the required earnings growth goes up by that amount. We would be paying up front for significant growth.

COMPANIES MUST COMPOUND EARNINGS SIGNIFICANTLY TO MEET THEIR PEERS

	Trailing P/E Multiple	Required Earnings Growth Per Year (5 Years)
Hindustan Unilever (India)	**44x**	14%
Unilever Indonesia	**58x**	20%
Unilever (U.K.)	23x	
HM Sampoerna (Indonesia)	**43x**	14%
Philip Morris Intl. (U.S.)	22x	
Asian Paints (India)	**56x**	19%
Sherwin-Williams (U.S.)	23x	
Nestlé India	**50x**	17%
Nestlé (CH)	23x	
Bumrungrad Hospital (Thailand)	**43x**	17%
Universal Health Services (U.S.)	20x	

Source: Bloomberg

The "Winning by Not Losing" Strategy

So what does a "winning by not losing" strategy look like for investors?

- **Employ independent thinking and research,** rather than chasing winners or following the crowd. As Ben Graham said, "The stock investor is neither right or wrong because others agreed or disagreed with him; he is right because his facts and analysis are right."
- **Follow a business approach to ownership (bottom-up).** Since risk comes from not knowing what you are doing, we can minimize mistakes by understanding what we own and staying within our circle of competence.
- **Choose business partners carefully.** Typically in emerging markets investing, when you pick a stock you also pick a partner.
- **Focus on quality.** Select businesses that are resilient, that sell everyday products and services, and that can survive and pull ahead in tough environments.
- **Invest with a margin of safety.** Hit well above the net to give yourself a margin of safety and pick a target inside the line, not on the line.

"Winning by Not Losing" in Practice

Let's explore how we apply the "winning by not losing" strategy to our investment approach. It seems appropriate to go back to Brazil, a market in which macroeconomic uncertainty did not provide investors with any comfort. But to quote Warren Buffett:

> *"Imagine the cost to us, if we had let a fear of unknowns cause us to defer or alter the deployment of capital. Indeed, we have usually made our best purchases when apprehensions about some macro event were at a peak."*

At Burgundy, we have made investments in Brazil since 2009. While our investments cover a diverse range of businesses, we will illustrate the point with reference to a case study of the Brazilian payments industry. We have owned two businesses in this sector: Redecard (until it was taken private) and now Cielo.

Focus on Quality

The payments industry in Brazil boasts a number of very attractive characteristics.

- It takes a fee on a growing industry. A small toll is exacted on the billions of transactions that flow through millions of merchants every year. Card payments as a percentage of total consumption in Brazil remain well below half the level of the U.S. As consumption grows and more spending gets done on plastic, the payment industry benefits.

- Three merchant acquirers – Cielo, Itau Unibanco's Redecard and Santander's Getnet – represent more than 90% of the industry. While the industry is competitive, it operates as a rational oligopoly. A merchant acquirer is a company that processes credit and debit card payments on behalf of merchants. Along with the credit card brand owners, such as Visa and MasterCard, and the credit card issuing banks themselves, merchant acquirers represent a critical component of an economy's credit/debit card infrastructure. With market share exceeding 50%, Cielo is Brazil's largest merchant acquirer.
- Competitive advantages of scale and distribution favour the largest players. Cielo's controlling shareholders – two of Brazil's largest banks, Bradesco and Banco do Brasil – represent 45% of the country's bank branches. This is important because bank branches serve as a low-cost acquisition channel for new merchants.
- In countries prone to inflation and a high cost of capital, the best types of companies to own are those that have an inflation-protected revenue model and little need for ongoing capital reinvestment. A fee on nominal spend indexes us to inflation. Capital requirements are mainly to buy point-of-sale equipment, which is then leased to the merchants.

The high-quality nature of these businesses can be exemplified by Cielo's financial characteristics. Since its public listing in 2009, the company has compounded its top and bottom line by strong double-digit growth rates. The business does not require much capital; and hence, the return ratios are very high. Cielo has used its balance sheet prudently during the current crisis to expand its business and moat – firstly into prepayments and more importantly through mergers and acquisitions. Current debt ratios remain reasonable and management is focused on paying down debt. The company is thus positioned well for an eventual recovery.

Invest with a Margin of Safety

It was macro apprehensions that gave us our initial entry point in 2009 as shares traded down below their IPO level. Regulatory uncertainty in 2010 gave us an opportunity to add to our position weight. Regulators wanted more competition, clearly a negative, but we also understood that the strong moats in the business were built on scale and distribution, two factors that were not going to change. Again in 2013 and early-2016, the market served up opportunities, largely on poor Brazil sentiment.

The point being that, while the stock market has been tumultuous throughout our holding period, these businesses have continued to grow their earnings base.

Apprehensions about macro events, in fact, were what gave us opportunities to buy or add at attractive margins of safety.

Today, Cielo's valuation is in line with where we see the Burgundy portfolio trading as a whole. The discount to intrinsic value, or margin of safety, should allow us to modestly exceed our long-term return hurdle rate. At current prices, we will continue to own the stock unless we uncover better opportunities elsewhere – but these seem hard to come by today.

Choose Business Partners Carefully

Valuation estimates are just estimates, and our intrinsic values do not explicitly give value to the ability of a business to adapt or to be opportunistic – those are free options. "Never let a good crisis go to waste," Winston Churchill said. Likewise, we find that great businesses led by capable managers find ways to turn crisis to opportunity.

To prop up economic growth, President Dilma's administration pushed public sector banks to lend more than they should have. This led to capital shortage in the sector and, with the equity markets unco-operative, allowed Cielo to strike a deal with Banco do Brasil on very favourable terms. In the joint venture, Cielo shares in the interchange fees from the bank's credit card division in exchange for performing card-related back-office operations for the bank. As earnings here are tied to a more resilient revenue stream, and again avoid any credit risk for Cielo, we see this as a highly constructive strategic move. Expanding when others are forced to retreat makes perfect sense to us.

Conclusion

Investing is a game of patience. In times of full valuations, which we think these are, it is tempting to "go for a little more" by hitting for the lines – or in this case, hitting for the "exact middle of the outer part of the edge of the front part of the back part of the line"!

Knowing what you own, avoiding unforced errors and hitting with a margin of safety are all key to staying power. These are the times of "winning by not losing."

Author: **Anne-Mette de Place Filippini, Senior Vice President and Portfolio Manager for Emerging Markets equities**

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10. Munger, Berkshire Hathaway AGM, 1994
11. Buffett, Berkshire Hathaway AGM, 1994
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25. Grant, *Grant's Interest Rate Observer*
26. Buffett, "A Tribute to Ben Graham"
27. Moore Corporation, AGM, 1995
28. Moore Corporation, announcement
29. Buffett, Speech, New York Society of Financial Analysts, 1994
30. Buffett, Berkshire Hathaway Annual Report, 1989
31. We used a median because some of these companies went from penny stocks to TSE stalwarts over the five-year period – especially in the oil and gas sector – which distorts the average number. For example, Canadian Natural Resources appreciated 1,347% in the period – pretty spectacular, but not all that meaningful if it's grouped in with Westcoast Energy's 9% total return. A median is a statistical device that chooses, in this case, the 30th stock in the sample as representative, because there are 29 stocks both above it and below it in the sample.
32. Buffett, Berkshire Hathaway Annual General Meeting, 1996
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40. Buffett, Berkshire Hathaway Annual General Meeting, 1996
41. Graham, *Ladies Home Journal* article
42. Buffett, Berkshire Hathaway Letter to Shareholders, 1990
43. Buffett, Berkshire Hathaway Letter to Shareholders, 1990
44. Buffett, Berkshire Hathaway Annual Report, 1993
45. Buffett, Berkshire Hathaway Annual Report, 1987
46. Donne, "Meditation 17"
47. Wyndham Hotel Corporation, Prospectus Summary, 1996
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50. *The Financial Post*, August 19, 1998
51. *Network*, 1976
52. Lynch, *One Up On Wall Street*
53. Shakespeare, *Hamlet*

54. Shakespeare, *Hamlet*
55. Miller, "Amazon and the Ethics of Belief"
56. Miller, "Amazon and the Ethics of Belief"
57. Standard & Poor's website (www2.standardandpoors.com)
58. Standard & Poor's website (www2.standardandpoors.com)
59. Voltaire, *Candide*
60. Mattingly, *The Defeat of the Spanish Armada*
61. Prior to May 31, data are taken from *Stocks for the Long Run* (Siegel). From May 31, 1993 to October 31, 2001, data are taken from Bloomberg.
62. Grant, *Grant's Interest Rate Observer*
63. Di Giorgio Corporation, DG Foods Prospectus, 2002
64. Di Giorgio Corporation, DG Foods Prospectus, 2002
65. Di Giorgio Corporation, DG Foods Prospectus, 2002
66. Some companies in America appear to be assuming that such a reversion is in fact underway. Berkshire Hathaway is using only a 6.5% assumed return going forward. But then, maybe Buffett and Munger lack the investment skills of these other companies.
67. Much of the data in this report and a considerable amount of the simplified explanation of pension accounting come from an outstanding piece of research from Credit Suisse First Boston's accounting analysts, David Zion and Bill Carcache, both CPAs. The report is entitled "The Magic of Pension Accounting" and appeared on September 27, 2002. Work like this could quickly repair Wall Street's reputation for superficial and partial research.
68. Just in passing, it is astonishing that a company showing an expense this insubstantial on its income statement should object to expensing stock options.
69. Buffett
70. *Merriam-Webster's Collegiate Dictionary*, 538
71. BCE, Annual Report, 1988
72. BCE, Annual Report, 1988
73. This date was selected because that is as far back as our annual report library goes. It encompasses enough history to make our point.
74. Valued using a dividend discount model where V = D/(R – G); V = Value, D = Dividend, R = Discount Rate, G = Growth Rate of Dividend.
75. Statistics are for Molson's Canadian brewing business only in fiscal 2004, under the overly conservative assumption that the other unprofitable assets are worth nothing.

76. On "a last 12 months" basis.
77. Based on fiscal 2002, the year of the Carling acquisition.
78. Total value of the company's equity plus debt divided by EBITDA.
79. Total value of the company's equity plus debt divided by EBIT.
80. Jordan, *American Metal Market,* Sept. 25, 1985
81. Watson Wyatt
82. Bloomberg News, April 24, 2006
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93. Attributed at Sun Valley Conference, July 1999
94. Adjusted for goodwill amortization.
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106. Taleb, Nassim Nicholas, *Antifragile: Things That Gain from Disorder*. New York: Random House, 2012

107. *Quod licet Iovi, non licet bovi,* translated from Latin, essentially means gods may do what cattle may not.

108. Net-net: an investment where a company's current assets exceed both its current and long-term liabilities. For Graham, an attractive equity investment is one where a company's market value is below the value of its net-net working capital.

109. Originally known as the Burgundy Japan Fund and restricted to Japanese equities up until December 2006. While still highly focused with no less than 85% invested in Japan, the strategy has since been broadened to include investments in other parts of Asia.

110. Another share award is called a restricted stock award, which involves immediately issuing shares that do not transfer to the employee until vesting. These awards are unpopular in Canada because of their unfavourable tax treatment.

111. Before 2011, Canadian option holders were directly responsible for paying the taxes on stock option exercises. Starting in 2011, a change in tax legislation shifted the burden of collecting withholding taxes on stock options to the employer. In practice, employees usually instruct their employers to sell enough of their share entitlement to fund the withholding tax liability, or employees write cheques to their employers for the withholding tax. The latter approach can also encourage employees to sell their shares to fund the payment to their employers.

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