Scott Leckie Intrinsic Value Management

Reflections

Investing for the future

National Bank Financial
280 King Street East, 4th Floor
Toronto, ON, Canada M5A 1K7
t 416 363 3050 – 1 800 665 1757
f 416 368 4330
www.LeckieIntrinsicValue.com

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The Blank Slate.

James Montier, a member of GMO asset allocation team and a leading authority on applying behavioural finance to investment, wrote in *Value Investing - Tools and Techniques for Intelligent Investing*[*]:

"Investors should consider the Buddhist approach to time. That is to say, the past is history and the future is a mystery, and so we must focus on the present. The decision to invest or not should be a function of the current situation (the value on offer) and not governed by prior experiences (or indeed our future hopes). Perhaps we would all do well to remember the sage words of King Solomon's advisers when charged to find an expression that would be 'true and appropriate in all times and situations', that 'This too shall pass'."

He later adds:
"*However, this blank slate is mentally very hard to achieve. Our brains seem to be wired to focus on the short term and to fear loss in an extreme fashion. These mental hurdles are barriers to sensible investment decision making in a bear market.*"

If you have ever seen a pack of wolves circling muskoxen, it is obvious the fear of injury makes them extremely cautious, whatever their hunger. We suspect it is the same deep "fear of injury" we have when confronted with the possibility of financial loss – the same fear of future helplessness be it because of broken bones for the wolf or financial destitution for us.

Our immediate fear however is just the manifestation of a deeply ingrained reflex, with no relation to the true reality of the actual situation. What James Montier says is that investors are usually ill served when they let such instinctive reflexes govern their actions. Being able to put aside such feelings and concentrate on the current reality, whatever the past, is what leads to better outcomes.

This month we will look at a few situations, where it appears instinctive reactions to not-so-great news has gotten the better of investors.

Theory and practice.

Right now - in the midst of this mid course correction - we should be doing exactly what some of you did during the financial crisis - buying more, and obtaining a better average price. This is what I am doing for all our portfolios that have the capacity to do so.

Yet, few of us do just that. Instead, we tend to assume our most recent experience is what the future will hold, while regretting earlier and easier times that we fantasize had no uncertainties attached to them – the power of insight! And so we do nothing, waiting to see if things are going to get better first. It is human nature, and it is usually wrong.

Of course, acting on lower prices does not apply to all securities. Sino-Forest has fallen a lot but may very well be a fraud. RIM has fallen a lot but it is difficult to understand whether their business has been permanently damaged and if their technology has been surpassed. Malcolm Gladwell recently talked about the interesting paradox whereby the company that is first with a new device or technology (i.e. RIM) is often not the ultimate success and that those who come later (Apple?) often ultimately thrive. Apple, he says, has made a business of coming late to the party.

So while some securities are impaired or at risk of being impaired others were cheap and became more so, having simply fallen victim to the prevalent bearish mood

[*] *Value Investing - Tools and Techniques for Intelligent Investing, Wiley 2009, p. 122 & 127.*

of investors. There are times when bad news is ignored and only good news is acknowledged. Today, good news is ignored and any sliver of bad news is just more fodder to justify the prevalent pessimism. *'This too shall pass'.*

Sherritt's Ambatovy mine.

Our position in Sherritt International is an example of such an opportunity. Sherritt announced that their huge nickel project in Madagascar would now pour first nickel in the first quarter of 2012 instead of the third quarter of 2011. This was a disappointment to the market and to us as we have been looking for the near term commissioning of Ambatovy to eliminate one of the three major discounts we have discussed as holding back the Sherritt share price. While a small setback to our timing, this delay and the afferent cost overrun do not have a major impact on our calculation of value. Many of you will recall that our 2008 bare bones calculation of intrinsic value for Sherritt suggested a fair value much higher than the current trading price (with no benefit from the Ambatovy project in Madagascar in our calculations -although some of the costs).

Another major opportunity to profit from Sherritt is from the "complexity discount" that exists in its share price. This can still be resolved - according to CEO Ian Delaney - sooner rather than later. Ideally, this would involve the uncoupling of the various divisions of Sherritt in order that their full value might be realized.

The final observation I will offer with respect to this security is that the late disclosure of a delay for the commissioning of the project came shortly after a period when the Company was in close communication with its shareholders (the annual meeting was only in late May). This will decrease the credibility of management for some shareholders. I acknowledge this issue but feel that the underlying value in the business is such that owners will benefit substantially beyond the current share price. Currently trading at 7x earnings, with a dividend yield of 2.4%, and a book value of $12 per share, Sherritt remains cheap.

Evertz's Middle East sales.

Evertz Technologies is a company selling equipment allowing television stations to provide their broadcasts in High Definition. Evertz recently reported that, surprise surprise, their sales in North Africa and the Middle East had been lower than expected due to the troubles being experienced in these parts of the world. This caused the share price to fall from $16 to $13. Is such a drop justified?

Let us step back and consider the bigger picture. Evertz stands in front of a huge wave of television stations that are going to convert to HD. The analyst at BMO keeps a proprietary database on conversions and believes that in the US market alone, 58% of news studios still have not converted. Evertz is recognized as one of the best companies in its field. Two independent surveys conducted by my staff (we are gearing up to do a third) over the past 4 years have confirmed that this is the case. The Company has $192m in cash and no debt. Adjusting for this cash, the Company trades at approximately 10x trailing earnings. Finally, prior to 2008 when broadcasters' budgets were less constrained, Evertz enjoyed an average growth rate of 47%. One does not have to believe in a return to such heady times but rather, reasonable business conditions, to see that Evertz' earnings can grow substantially and attract an expanded multiple. Evertz, even with currently slower sales in the Middle East, remains a good company trading at a modest valuation.

Scott Leckie & Jean-Dominique Sellier
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