Reflections

Partners in Capital Growth

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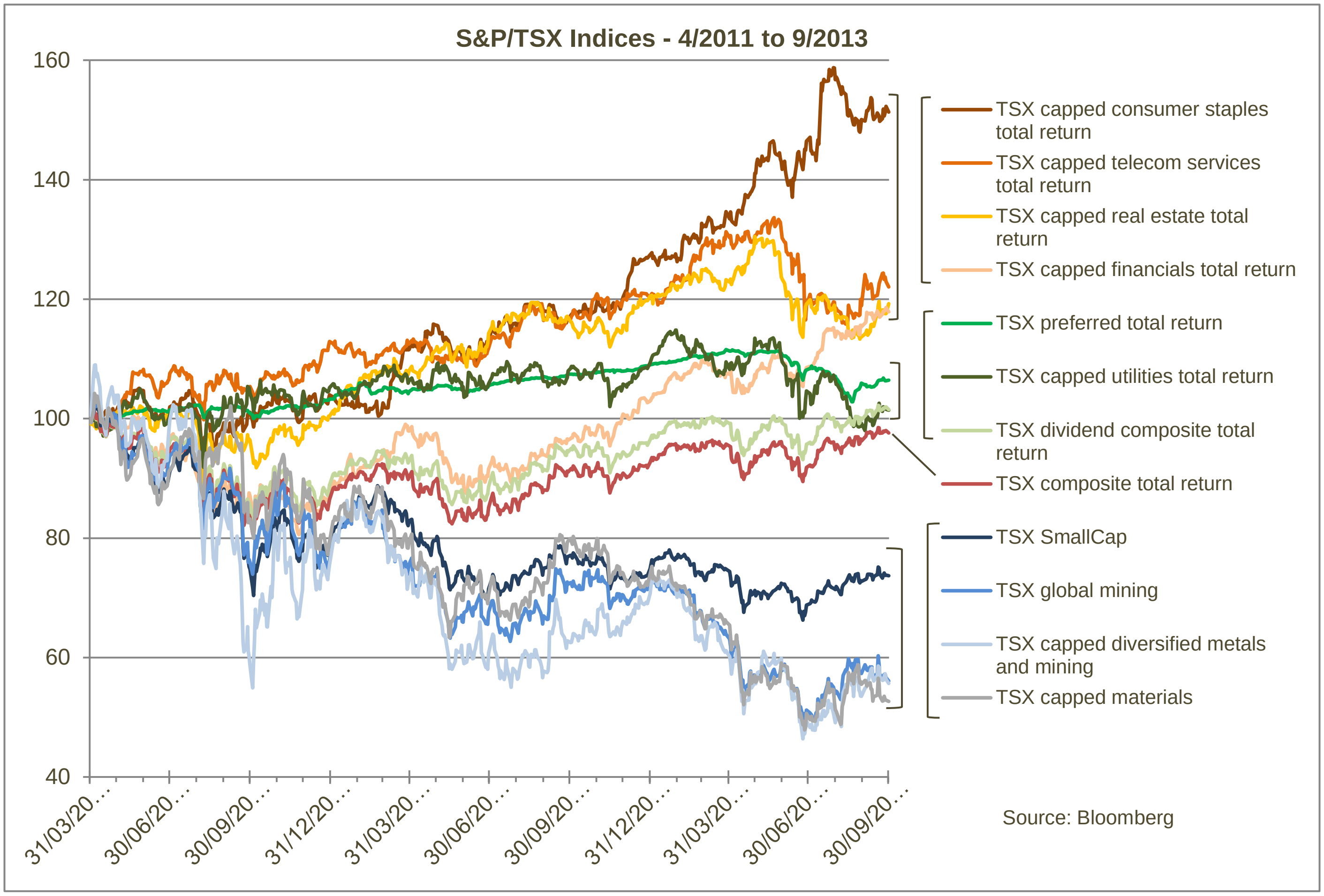
From Market Preferences to Opportunities



TSX Sub-Indices since the market high of 2011. The graph above shows select equity sub-indices of the Toronto equity market that illustrate investors' fears and preferences since the market high of early April 2011.

The financial crisis of 2008 had initially prompted most governments to introduce measures to stimulate their economies. With a devastated real estate market (real estate being a significant contributor to economic growth), over-borrowed consumers became afraid or unable to spend. Businesses, facing a sudden drop in revenues, stopped investing. Governments were left as the only ones with the ability to compensate for the lack of demand, and their interventions (stimuli) led to a rebound that culminated with the market high of early April 2011, Investors had regained some confidence and the hope that the crisis would be as short-lived as previous ones.

Unfortunately, starting in 2010, a number of countries started to reduce or eliminate their stimulus packages and instead implemented austerity measures that reduced government spending at a time consumer demand was far from having recovered. The subsequent and inevitable decline of economic activity caused many countries, especially in Europe which had the strictest austerity programs, to plunge back into a deep recession from which they still have not recovered.

Out of fear that this crisis could last longer than expected and with interest rates at still record lows, many institutional investors reduced their participation in public markets to focus on private equity, infrastructure projects and other investments with steady state cash flow characteristics.

Meanwhile, the retail investors who had remained in the market after the financial crisis became focused on yield based instruments – be they fixed income products, preferred or dividend bearing equities.

The impact of such preferences on market prices is well illustrated by the TSX sub-indices graphed on the first page:

- The best performing shares are those of large companies in sectors that investors traditionally like or think they know well: consumer goods, telecom, real estate, and financials like banks and insurance companies.
- Next are the yield generators: preferred shares, dividend bearing equities and utility companies.
- The above selections outperform the TSX itself.
- Under-performing are sectors that can easily appear riskier: smaller companies and market sectors that traditionally do better at a higher point in the economic cycle, such as materials, metals, mining.
- Furthermore, as neglected shares are usually thinly traded they tend to have a higher short-term volatility. This can easily be seen in the bottom segment of the front page graph.

And there lies the opportunities...

Investors' neglect of some sectors, like is so obviously happening now, is often a great source of mispricing, and therefore opportunities for the discerning and patient investor.

The fact that some shares are neglected by investors and therefore cheap does not mean that the underlying company is unhealthy or worth its poor market valuation. Conversely, there are many examples of expensive shares beloved by investors that had to suddenly face the demise of the underlying company. Unsettled or uncertain markets are always a source of such opportunities, as fearful investors take refuge in conventional "safe" sectors, pushing up their price to unrealistic levels. Meanwhile, the neglected sectors languish whatever the healthy progress made by these companies.

An extreme example of this is our current ability to buy shares in companies that have a resource name but no business other than cash held on the balance sheet for 50 cents per $1.00 of cash. Long time Takota investors remember the eventual positive outcome of previous such opportunities to "buy cash" (or cash equivalent) at a substantial discount (Dynatec, Westaim, etc.).

Our portfolios also include many companies that trade at major discounts to their fair value and have been trading as such for longer than we are accustomed. Because of this unusual 'time lag" between investment and realization, it is sometimes said by market observers that "value investing is dead". We do not believe this to be true. While the number of equity market participants has dwindled in Canada for the time being, as described above, whenever there is a business trading at a price well below its business value you can be assured that eventually someone will take advantage of it. It may be a competitor, it may be insiders of the Company itself, or it may be one of the private equity players that have recently received so much institutional cash - but somebody will. And when that happens, or when the market changes mood because finally a more sustained recovery is in the works, the price of these assets will rise toward their intrinsic value.

We estimate that our portfolios are currently trading at about a third of their potential intrinsic value. With the underlying companies continuing to develop, this obviously cannot last. It may still take some time before changes occur, but we expect that, given the way markets are currently skewed, any reversal would be quick leaving unprepared investors little time to adjust.

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