

Our commentary is atypical this quarter. If you're looking for our insights into your Portfolios or discussions of businesses you own, please skip this commentary and go directly to our website at [www.edgepointwealth.com](http://www.edgepointwealth.com). There you'll find video of our discussions from Cymbria Investor Day held on May 21<sup>st</sup>, 2014. While specific to Cymbria, many of the topics will be relevant to your Portfolios. The sections which will be of particular interest to you will likely be Chapters 5 to 9.

**The value of sound advice**

By Tye Bousada, portfolio manager

There's a fair amount of uncertainty in the markets today. Will China slow further or won't it? Will the situation in Iraq escalate causing the price of oil to spike further? Are valuations too stretched after more than five years of a bull market? Where will interest rates be a year from now? Will corporate profit margins return to a more normalized rate from what appears to be an elevated level today?

Although these are all valid questions, they are short-term risks. Our investment approach, which we've written about extensively in the past and will address aspects of later in this commentary, has helped us navigate through a variety of historical risks and we believe will continue to serve us / you well over the long term.

With this as a background, we believe the biggest financial risk you face is not outlined in the first paragraph above. The reality is the biggest single financial risk that you face is that you'll live a long time.

If it is your goal to live a long life, then it's our belief that a good financial advisor can help limit the financial risks you'll inevitably face on the road to achieving your goal - so you can actually afford to live that long life.

Let us state up front that we aren't cheerleaders for the entire financial advisory community. According to Advocis, the Financial Advisors Association of Canada, there are over 90,000 advisors in this country, and we deal with only 3% of them at EdgePoint (Source: [Advocis](#)). The



hard reality of math is that over 45,000 advisors in this country are below average and 85,500 don't rank in the top 5%. If we asked you whether you'd prefer to have an advisor in the top 5% of their field or the bottom 95%, the answer would be obvious. Therefore, it shouldn't surprise you that when we started EdgePoint, we set out to deal solely with those advisors who had the ability to add the most value for their clients over the long run.

We thought we'd spend some time during this quarterly commentary discussing why we partner with the advisors that we do. More specifically, we've attempted to identify a few of the key attributes that we look for in advisors before we try to partner with them. In our observation, advisors with these attributes have generally been more successful at helping their clients meet their financial goals:

### **Attribute #1**

The advisors we try to partner with are more focused on getting you to Point B and less focused on the stuff around Point A.

You're at Point A today and have a financial goal, which we'll call Point B, sometime in the future. Many investors are in search of the secret path of success to Point B. You know the path we are talking about – the magical low volatility, high return investments that can double your money in a flash, and never make you feel uncomfortable to be invested in them. Here's the problem with that path, we aren't aware of anyone that has found it – ever. However, in spite of the fact that the path is pure fiction, the vast majority of the financial services industry attempts to make you believe they can offer it to you.

The reason the industry is successful at selling the average investor the wrong thing at the wrong time is because many investors focus on all the noise around Point A (the predictions, the obsessive search for trends and the intense scrutiny of day-to-day market activity), and the majority of the industry plays on that short-term focus. For example, during periods of fear in the capital markets, the industry will try to sell you investments that promise "low volatility and guaranteed rates of return". The problem with this strategy is these investments are already expensive because everyone else is buying them. Likewise, when everyone is enthusiastic about the future, the industry will try to sell you whatever currently has the best performance. Again, not because it's necessarily good for you, but because it's easy to sell.

Getting caught up in all the short-term noise around Point A means a lot of investors make financial decisions that will result in them never achieving their financial goal (or Point B), because a good chunk of the financial services industry is geared towards selling products that play on the human emotions around Point A.

Since the inception of EdgePoint, our Portfolios have not been easy for financial advisors to support. First of all, EdgePoint has not been a household name like many other companies in the industry. Secondly, we haven't tried to become a household name through advertising, choosing instead to re-invest the money that we could have spent on fancy commercials into lower fees for you, the end investor. Thirdly, we told the financial advisors we were thinking about partnering with that the performance of EdgePoint Portfolios could be volatile at times as the markets gyrated.

One of the most important things an advisor can do to help their clients reach Point B is to recommend what their clients need instead of what makes them feel good in the short term. When your advisor convinced you to invest in EdgePoint Portfolios, they believed it was what you needed. Prior to your advisor talking to you about EdgePoint, you had likely never heard of us. You had never seen a commercial from EdgePoint. No one was talking about us at cocktail parties or your kids' soccer games. To boot, your advisor was likely recommending EdgePoint Portfolios during a time when the markets were volatile and when most investors would have preferred to buy a "low volatility" investment like a government bond.

Instead of taking the easy path and selling you what made you feel most comfortable around Point A, your advisor tried to identify what you needed to get to Point B, and recommended you buy that instead. Their focus on your Point B is the first way that an advisor adds value for you.

## **Attribute #2**

The advisors we try to partner with have convictions and invest behind them.

There are over 16,212 funds in Canada to choose from (Source: [The Fund Library](#)). Your advisor has to sift through all these investment alternatives and find the ones best suited for you. They constantly gather facts and apply reasoning to those facts to come up with convictions that they can invest behind.

The gathering facts part usually involves reading all sorts of material from investment management companies, analysis of historical results, interviews with investment management representatives (including portfolio managers) and industry analysis.

The reasoning part is a little less scientific, however, no less important. Reasoning is judgment based. Their judgments allow them to form convictions which form the basis of their recommendations.

Advisors with a high conviction approach stand behind an investment philosophy and core set of beliefs that they stick to through the inevitable ups and downs of the markets. These convictions aren't always popular and at times will seem difficult to defend. But, convictions built from extensive research and sound judgment result in the development of recommendations that advisors can have confidence investing behind.

The advisors that we partner with understand and believe in the EdgePoint investment approach, and have the conviction to recommend it. This investment approach can briefly be described as follows:

We're long-term investors in businesses. We view a stock as an ownership interest in a company and endeavour to acquire these ownership stakes at prices below our assessment of their true worth.

We believe that the best way to buy a business at an attractive price is to have an idea about the business that isn't widely shared by others – what we refer to as a proprietary insight. We strive to develop proprietary insights around businesses we understand. We focus on companies with strong competitive positions, defensible barriers to entry and long-term growth prospects that are run by competent management teams. These holdings generally reflect our views looking out more than five years. We firmly believe that focusing on longer periods enables us to develop proprietary views that aren't reflected in the current stock price.

Our approach is deceptively simple. We buy good, undervalued businesses and hold them until the market fully recognizes their potential. Following this approach requires an ability to think independently, a natural curiosity necessary to search out new ideas and a commitment to

embrace the thorough research required to uncover opportunities the market doesn't fully appreciate.

The deceptive part of our approach is that sometimes you need to look wrong in the short term to be right in the long term, and that isn't always easy to do or support if you are an advisor. As mentioned earlier, our performance since inception has been pleasing but hasn't always been easy to support. Since our inception in 2008, we've had three different periods where we looked dumb. These periods resulted in us trailing our respective benchmarks. Your advisor had conviction in the approach and our ability to execute against it. As such, they continued to recommend that you hold your position, or in some cases even suggested that you add to it, which would have resulted in an even more pleasing return for you.

It's their ability to act on their convictions that leads to the second way that your advisor adds value for you.

### **Attribute #3**

The advisors we try to partner with live in a narrow emotional band.

The best portfolio managers live in a narrow emotional band. They never get excited when things are going their way, and never get down when things are moving against them. They stay focused on the facts. The same is true for the advisors, who in our judgment add the most value.

The markets are irrational due in large part to the human emotions of fear and greed. The best example of this is how the markets fluctuate up and down by significant amounts over short periods of time. Businesses don't experience wild changes in value on a daily basis, but when you add emotion into the mix, they suddenly do.

At the end of every day, commentators will pontificate about why the markets did what they did that day, but it's almost all nonsensical noise. I've yet to hear a commentator tell their audience the truth, which would sound something like this: "The markets gyrated a lot today, but the underlying business values didn't really change all that much. The root cause of the gyrations was reporters like me reporting stuff of little value which somehow had an effect on the human emotions of fear and greed".

Shutting out this noise is a valuable skill. The resulting narrow emotional band keeps your advisor focused on the important stuff for you.

#### **Attribute #4**

The advisors we try to partner with understand emotional biases.

As humans we're hardwired with behavioral biases. Many humans, including yours truly, suffer from behavioral biases at times when it comes to financial decisions. Changing our genetic makeup to free ourselves of these biases is not an option, so the next best thing is to be aware that they occur. Awareness helps us fight them. As portfolio managers, we frequently have to consider whether our judgments are impacted by any of the following biases. Similarly, our advisors regularly question whether they or their clients suffer from one of the following:

1. **Confirmation bias** - the tendency for people to favour information that confirms their beliefs

The effect is usually stronger for emotionally charged issues (like money). This can lead to misplaced confidence when it comes to investment decisions, which in turn often results in investors never reaching their Point B goal.

2. **Loss aversion** - the tendency to strongly prefer avoiding losses to acquiring gains

As investors, we hate losing money much more than we love making it. Volatility in the capital markets, however, is a fact of life and most investors need some small part of their portfolio invested in businesses in order to achieve their Point B financial goal.

3. **Recency bias** - the tendency to extrapolate recent events into the future indefinitely

EdgePoint Global and Canadian Portfolios have returned compound annual rates of return of 18.01% and 18.06% respectively since inception. It'd be wrong to extrapolate this into the future when planning for your Point B. A scary example of this is a story that Nick Telemaque, one of our internal EdgePoint partners, told me the other week. Nick recently met with an advisor whose client was suffering from this bias, wanting to make an investment decision based on

how well the markets had done over the last six months. In our judgment, this is a sure fire way to not achieve your Point B plan.

#### 4. **The planning fallacy bias** – the tendency to over-estimate our planning and execution skills

In the book “Thinking Fast and Slow” by Dan Kahneman (a book given to us, your portfolio managers, a few years ago by EdgePoint co-founder, Bob Krembil), Mr. Kahneman outlines what he calls the planning fallacy. It’s the tendency to underestimate the time, cost and risks of future actions and at the same time overestimate the benefits of those actions. This bias can lead people to save less than they need to today with the belief that everything will work out in the future. Unfortunately this failure to save adequately jeopardizes their ability to achieve their Point B plan.

Many wouldn’t think that psychology could play such an important role in financial well-being, but being aware of these biases is important. The advisors we try to partner with have experience identifying and working through these biases with their clients.

### **Conclusion**

The best portfolio managers in the world can’t predict the stock market. The best they can do is create the circumstances for success through the application of their investment approach and let the outcomes play out. Like portfolio managers, the best advisors can’t predict the future either. Instead of an investment approach to fall back on, they have a framework of positive attributes to help them create the circumstances for success. In our judgment, the advisors with these attributes have a better chance of getting their clients to their goals at Point B. These attributes are tough to develop, and that’s why we only partner with a minority of the industry.

### **A reminder**

As mentioned at the beginning of the commentary, if you’re looking for our insights into your Portfolios or discussion of businesses you own, then please go to our website at [www.edgepointwealth.com](http://www.edgepointwealth.com).

We're mandated to include standard performance here only because Tye references since inception returns in his commentary. If it were up to us, we wouldn't bother. We measure investment success over periods of ten years or more and place little value in the short-term investment results shown.

Annualized returns as at June 30, 2014:

EdgePoint Global Portfolio, Series A

YTD: 6.06%; 1-year: 23.84%; 3-year: 16.98%; 5-year: 14.22%; since inception: 18.01%

EdgePoint Canadian Portfolio, Series A

YTD: 9.17%; 1-year: 26.34%; 3-year: 11.11%; 5-year: 14.69%; since inception: 18.06%

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