The McValue Portfolio Newsletter

September 2009

"[Intrinsic Value is] an all-important concept that offers the only logical approach to evaluating the relative attractiveness of investments and business. Intrinsic value can be defined simply: It is the discounted value of the cash that can be taken out off a business during its remaining life." Warren Buffett – 1999 Annual Letter to Berkshire Hathaway Shareholders

Friends,

In the past I have often shared with many of you the details and timing of my latest stock picks knowing that you are all "over 21" and can make your own investment decisions. Some have occasionally followed my lead with what I hope have been satisfactory results although my record has been far from perfect. Rather than continue to informally provide you with my latest thinking on the subject, I decided that it was time to start to put my thoughts on paper for several reasons.

First and foremost, it is easy to proclaim that one is a good investor by talking about the winners and conveniently changing the discussion when it comes to the losers. At the suggestion of a friend (thanks Charlie!), my hope is to create an objective long-term record of my progress for better or worse. Nothing focuses my mind better than the risk of looking foolish in front of people who I like and respect. Secondly, over the years I have discovered a successful investment framework - Value Investing - and wanted to pass along some of what I have learned (don't worry – I won't show up at your door on a weekend with briefcase in hand). My "mentors" on the subject (Graham, Dodd, Fisher, Munger, Buffett, etc.) have been more than generous with their thoughts and all that my investment education cost me was a few hundred bucks in books at Amazon.com and photocopying at Kinkos. Finally, I find that writing things down helps to clarify my thinking when it comes to investing.

Value Investing

One of Canada's most prominent and successful investors has said to me that there is more than one way to make money in the market. While that may be true, I have found Value Investing to be a framework that works for me as it is based on common sense and solid logic. A recent Standard & Poor's study showed that less than 8% of Canada's professional money managers beat the S&P/TSX Composite Index over a five year period. A disproportionate number of those star performers are talented value managers. Unless a money manager can beat the benchmark over a period of time there is no reason for them to exist. You would be better off buying a low-fee index fund.

The reality is that most people with day jobs don't have the time to invest properly or the desire to try. However, even for those that do, there are pitfalls. I believe that many well-meaning but misguided analysts, portfolio managers and investment advisors continue to focus on the wrong things. For example, some "investors" (and I use the term loosely) focus on market timing and technical analysis both of which I generally ignore.

I think that I have given away more that a dozen copies of the best book on investing ever written – Benjamin Graham's *The Intelligent Investor* - but have yet to have even one recipient take to the subject. Most find the subject matter about as exciting as watching paint dry (*Hint: just read Chapter 8 regarding "Mr. Market" and Chapter 20 about Margin of Safety*). Given my failure at converting these recipients, I promise to keep my letters light.

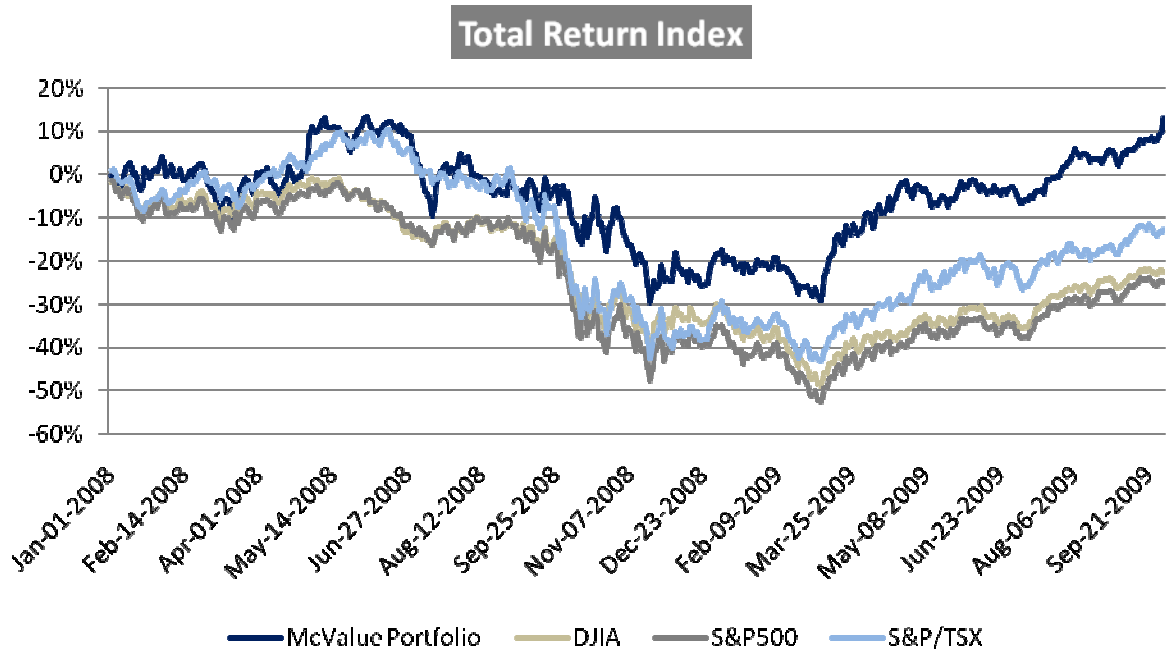
On that note, let's start off with the fundamental concept. Value Investing is all about buying an interest in a quality business for less that its Intrinsic Value. An excellent definition of Intrinsic Value is reproduced in the margin of the prior page. Intuitively the Intrinsic Value concept makes sense. When investing, you are giving up a dollar of consumption today in exchange for a future payout that is expected to be higher to compensate you for inflation and the investment risk you are taking.

The key steps involved in Value Investing are identifying businesses that you can understand, that possess attractive underlying economics, being run by competent and shareholder-friendly management teams. These attributes should allow you to predict future results using conservative estimates and come up with a reasonable estimate of Intrinsic Value. The next step is easy (but often ignored). You just need to wait for Mr. Market to offer you a price that you can buy the stock for at a sufficient discount to your estimate of its Intrinsic Value. If you don't like today's offering price, just wait a day – Mr. Market will be back the next day … and the next with another offer.

If you have done all of the foregoing correctly then you just need to sit back, monitor the business to make sure that there is no fundamental change to your investment thesis and let time and compounding do their thing or for the market to finally figure it out and value the business properly. While inactivity bordering on sloth is the goal, it doesn't endear value investors to brokers who rely on trading commissions for a living.

My Recent Track Record

2008 was a year that most investors, myself included, would prefer to forget. However, I thought that it was only fair to start tracking my performance in a difficult market. You will be pleased to know that you are taking time out of your day to read the ramblings of a market "guru" who put up a remarkable *minus* 19.6% return in 2008. That said, I was quite happy with my results relative to the major benchmarks as my personal goal is to beat them by an average of 10% per year over the long term. More important than my results for the year was the fact that I managed to keep my wits about me throughout the downturn and loaded up on some stocks that I thought were being given away. My patience was rewarded in 2009 (so far) as I am up 40.7% year-to-date. I would caution you that this 21 month period is insufficient to judge the track record of *any* investor. Three years is an absolute minimum and five years plus in good and bad market conditions is preferable. In other words, the jury's still out on my track record but I like my chances once they reach a verdict.



	earl Results				
	McValue Portfolio[1][2]	S&P 500 [2]	McValue Portfolio Outperformance	S&P/TSX[2]	McValue Portfolio Outperformance
2008	-19.55%	-37.00%	17.45%	-32.95%	13.40%
YTD 2009[3]	40.69%	19.26%	21.42%	30.04%	10.64%
Total Return 2008 - 2009[3]	13.19%	-24.86%	38.05%	-12.80%	25.99%
Annual Compounded Return	7.33%	-15.07%	22.40%	-7.53%	14.86%
Standard Deviation[4]	22.94%	23.94%		23.66%	

[1] Based on invested capital (ignoring cash)

[2] With dividends included.

[3] To September 30, 2009

[4] Annualized and based on monthly returns since Jan 1, 2008.

You should know a few things about how I manage my own portfolio. I tend to have a very concentrated or a "conviction" portfolio. The size of my positions in various stocks varies materially based on my level of conviction at the time of purchase and the subsequent market action. Given that I neither use leverage nor do I short-sell, I have the benefit of never needing to sell when Mr. Market disagrees with me. Just as important, I have the temperament to be contrarian when I think that I am right and wait it out without losing my head while others often panic. Unless you can watch your portfolio decline by over 35% in any given year and not lose your cool, you probably shouldn't be in equities.

The benefits of broad diversification make sense for most but I prefer to make a few large bets on a dozen or fewer situations that I think that I understand reasonably well and where I like the risk/reward tradeoff. In other words – my best ideas. This strategy is not for most but I prefer to assume some shorter term volatility in exchange for what I expect will be longer term outperformance. I will not disclose my portfolio weightings or all of my holdings as you can discuss what works for you with your financial advisor (on that note please read the disclosure at the bottom of the last page). But I am happy to continue to share with you my thoughts on certain stocks that I like. Besides, I have to keep a few secrets!

You should also note that I track only the invested portion of my portfolio and ignore my cash position which constantly changes . This has the effect of overstating both my percentage losses in down periods and my percentage returns in up periods but all-in-all I feel that this is a reasonable way of presenting my performance.

Since the beginning of 2008 I am up a modest 13.2% but I like what I own and only wish that I had more time to invest the cash portion of my portfolio that is growing on a daily basis. The bargains are out there. I just need more hours in the day to look for them. Until I do, I would rather stay in cash than do something stupid. Just don't tell Marie France or she will have it spent before the weekend is out.

My Latest Pick

Those that know me best know that I always try and find companies in glamourous industries that make fascinating products so that I can impress people with my knowledge of the subject at cocktail parties. After tossing away many unsuitable candidates I finally found one – Hammond Power Solutions (TSX: HPS.A). And the sexy business is… wait for it … dry-type transformer manufacturing!

Hammond is the leading manufacturer of custom dry-type transformers in North America with an estimated 20% market share. A transformer is essentially an electrical device that transforms voltage – usually "stepping it down" for industrial use. Dry-type transformers use insulation mediums other than oil making them more environmentally friendly and are preferred for indoor applications due to lower fire risks. The types of transformers that you see outside are generally oil-type

A weak economy has already caused softening demand from Hammond's customers, increased credit risk and lower gross margins due to lower manufacturing utilization. The company also has significant exposure to raw material costs and a declining US dollar – almost a certainty over the medium term given the US administration's policy actions and America's ballooning debt. There are many additional risks on this one: an intensely competitive market, illiquidity (the stock trades by appointment), potential environmental remediation claims, a unionized work force, a multiple-voting class share structure that gives the CEO (Bill Hammond) effective control, a manufacturing business based in Ontario, etc.. This one is not for the faint of heart or the someone looking for a short term flip. Please read their Annual Report and latest Annual Information Form - both available at www.sedar.com – to see the many other risks.

So why do I like Hammond? The business was spun out of a larger family business that goes back over 90 years and three generations. My assessment is that management is hard working, pay themselves modestly, have been running the business for many years and they appear to focus on the right things (diversifying distribution and customers, return on net assets, earnings per share). The short term economic environment for Hammond is disastrous (Hammond's EPS last quarter was only $0.04) but over a longer period of time I think that they will continue to deliver superior returns on equity using minimal leverage. My initial thinking was that this is a commodity business but my thesis has changed. I now believe that their custom orders and focus on short-term delivery give them some pricing power and Hammond's improving gross margins over the past five years seems to confirm that. Finally, I think that the industry is likely to consolidate like it did in the last recession and Hammond is well positioned to be the consolidator.

Given the price at which bought the stock ($9.00) I think that I have a sufficient margin of safety even if I made a few mistakes in my analysis and should do just fine long term. But it is possible that Hammond will continue to disappoint in the short term given the economic backdrop. With Hammond's decent balance sheet I think that I have the luxury of time. The stock may well be dead money or decline further but at my acquisition price I think that I am getting good value and with my long-term time frame I am comfortable with the risk/reward. Never forget that *your ultimate return is a function of the price that you pay for a stock!* Stocks in great companies can still be terrible investments if you overpay for them.

***Selected* Current Holdings**

Astral Media
Berkshire Hathaway
Equitable Group
Hammond Power
MacDonald Dettwiler
Nike
TMX Group

***Selected* Former Holdings**

Home Capital
Precision Drilling
Royal Bank
Sprott Inc.
Starbucks
TD Bank
Urbana Corp.

My Most Recent Mistake

Selling early! Value Investors often buy and sell early. The smart ones stick to their guns on the way down (assuming that the investment thesis remains valid) and buy more at better prices. The tough part is learning not to care if the market doesn't agree with you at the time. Remember, you are neither right nor wrong just because the market agrees or disagrees with you at a point in time.

I recently left a significant amount of money on the table by selling my entire holdings in both Starbucks and Home Capital only to watch them appreciate materially after I sold them (by an additional 12% and 37% respectively). They have come off somewhat since then but I still haven't learned not to look after I sell.

Warren Buffett has evolved his thinking on selling since his early private partnership days. Warren currently believes in holding stocks in great companies forever (Fisher/Munger influence). I believe that this is partly a function of the large amount of the capital that he manages and the effect of taxes triggered by a sale. I continue to believe that both SBUX and HCG are trading above my estimate of their Intrinsic Value and I hold almost all of my investments in tax sheltered accounts so I will stay on the sidelines on both names for now. They may well go higher again but *c'est la vie*!

…Til the Next Edition

Assuming that you are still reading I think that this is more than enough of my self-indulgent rant for one session. I would be pleased to hear of any great investment opportunities that interest you or to chat about the dry-type transformer industry, anything in the letter that needs clarifying or investing in general. And remember – a wise many once said to me, "*free advice is usually worth what you pay for it*". *Caveat emptor.*

Best regards,

Michael.

The McValue Portfolio Newsletter

January 2010

Suggested Readings
(in descending order of their influence on the author)

***The Intelligent Investor* – Benjamin Graham**

***Common Stocks and Uncommon Profits* – Philip Fisher**

***Berkshire Hathaway Annual Letter to Shareholders (1978 – Present)* – Warren Buffett**

***Poor Charlie's Almanack* – Peter Kaufman**

***Security Analysis* – Benjamin Graham and David Dodd**

***Extraordinary Popular Delusions and the Madness of Crowds* – Charles MacKay**

***One up on Wall Street* – Peter Lynch**

***Buffettology* – Mary Buffett**

The Greater Fool

I want to start off this second edition by thanking everyone for the feedback on my initial newsletter. The response was overwhelming to say the least and my distribution list is growing. The feedback was generally positive but I did receive some very constructive feedback which I hope will add to future additions and which I continue to welcome.

Value Investing – How to Think About Stocks

Most people view the stock market as nothing more than a casino and the behaviour of many of its participants only reinforces this view. A recent article that I read in the *Globe and Mail* will help me to illustrate how I believe that investors should look at stocks.

A former investment banker based in New Jersey recently paid US$310,700 for an original Dracula movie poster being auctioned by the actor Nicholas Cage. Here is what this market professional said about his purchase:

> "I got out of investment banking a couple of years ago and started investing in posters … The prices keep going up for the really rare things, and I'd rather put my money in something tangible than in stocks".
>
> *Globe and Mail*, July 31, 2009 at B9.

No folks, I didn't make this up. It just goes to show you that you shouldn't be taking advice from an investment banker.

Similar to people that invest in continually unprofitable sports teams, rare art, Beanie Babies, etc., these "investors" are essentially betting that they are going to be able to resell the asset at some point in the future at a higher price and generate an adequate return. This is better known as the "greater fool" theory of investing. These assets do not generate any positive cash flows while being held and they do not generate any cash for their owners until they are sold. The investor is hoping that the asset in question will continue to be valued in the market at escalating prices. I recognize that there may be non-economic reasons for the purchase (prestige, ego, passion) but I am strictly commenting on their attributes as rational investments.

The crazy prices being bid for "dot.com" stocks in the late 1990s is another classic example. People were buying shares in startup.com that sported a multi-billion dollar valuation with little more than a business plan and often no revenue. Provided that a shareholder sold the stock before the music stopped in March 2000 they may have done quite well but it is important to recognize that this is truly gambling (or speculating as Benjamin Graham would say) and that over the long term the odds are against you.

Like a rare movie poster, a stock is something tangible. The proper way to look at a stock is that it represents an ownership position in a real business. Whether or not you own 100% of the business or one share in a multi-billion dollar enterprise should not matter when you evaluate the Intrinsic Value of either the company or that share.[1] In the latter case you are simply dividing your calculation of the business' Intrinsic Value by the number of shares outstanding.

[1] For purposes of simplicity I have ignored the benefits that accrue to a controlling shareholder which do typically result in a premium to that of a minority position.

Recall from my last newsletter that the Intrinsic Value of any asset is the discounted value of the cash flows generated by the asset over its useful lifetime. The starting point is determining a conservative estimate of that Intrinsic Value in a business with attractive economic characteristics and then comparing it with the price being offered in the market. If you can buy the stock at a sufficient discount to your calculation then you have a sufficient margin of safety and over the long term you should do quite well. If, on the other hand, the market is overvaluing a stock and you choose to buy it, you are betting that a greater fool will come along and pay an even higher price to take it off your hands in the future. While the outcome is not certain to be unsatisfactory, to those that follow the Value Investing philosophy two things are certain – the odds are not in your favour and investing this is not.

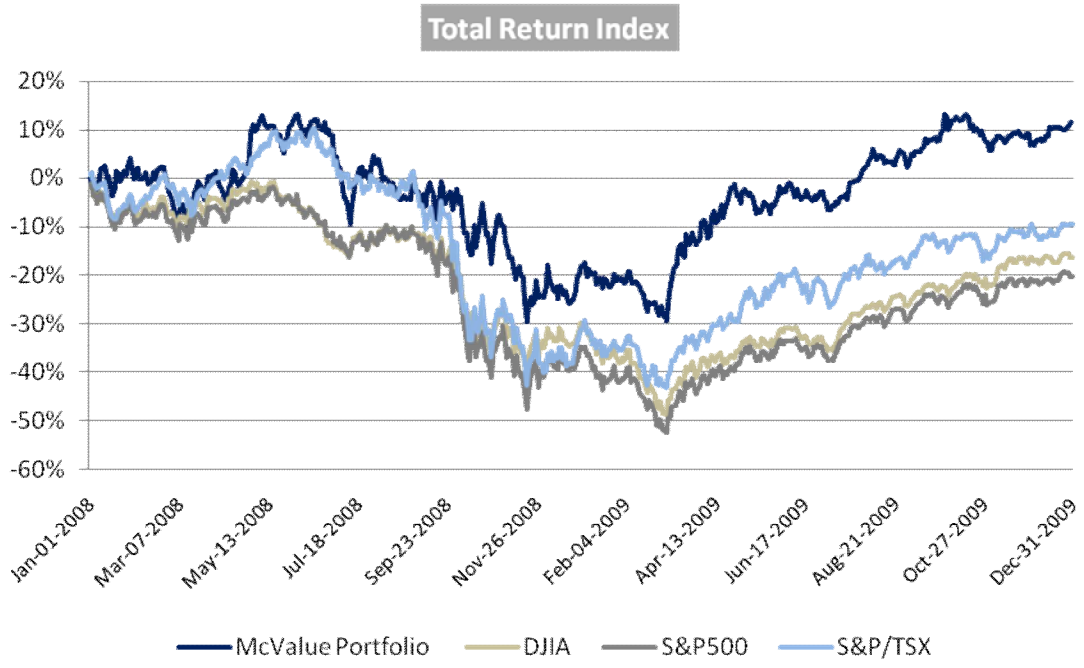
Once you understand this fundamental concept then you should be able to ace this little pop quiz:

1. If a stock used to trade at $50 but is currently trading at $20 a share, is it a good buy?
2. If you have an option of buying shares of company A at $5 per share or company B at $60 per share, which is the better investment?

As you have figured out by now the answer to both questions is the same – it is impossible to know as you don't have enough information to make an intelligent investment decision. If you keep this example in mind you will be stunned at how often this rationale is used when people tout their latest stock purchases.

2009 - The Year in Review

I lost some ground on the major indices in Q4 due to my portfolio's conservative positioning. My only trading activity was the sale of one of my holdings (Nike) as its recent price advance caused it to overshoot what I calculate to be its Intrinsic Value. That is not to say that I was inactive in the quarter. In this ever-rising market I took advantage of the last three months by re-reading some of my favourite investment books and a few new ones to boot. I wanted to further refine my stock-picking methodology and reinforce in my mind some of the investment principles set out years ago that remain as relevant today as they did long ago. More importantly, I wanted to identify and learn from the mistakes that I have made in the past (I assure you, there were plenty). For those with the desire to expand their knowledge on the subject, a list of some of my favourites is reproduced in the margin on page 1. My primary goals for this year are to spend more time screening stocks in order to deploy my growing cash position and to expand my Circle of Competence (a topic for a future edition).



	earl Results				
	McValue Portfolio[1][2]	S&P 500 [2]	McValue Portfolio Outperformance	S&P/TSX[2]	McValue Portfolio Outperformance
2008	-19.55%	-37.00%	17.45%	-32.95%	13.40%
2009	38.66%	26.46%	12.19%	35.05%	3.60%
Total Return 2008 - 2009	11.55%	-20.32%	31.88%	-9.44%	20.99%
Annual Compounded Return	5.62%	-10.74%	16.36%	-4.84%	10.46%
Standard Deviation[3]	21.87%	22.98%		22.75%	

[1] Based on invested capital (ignoring cash)

[2] With dividends included.

[3] Annualized and based on monthly returns since Jan 1, 2008.

My portfolio results for the year are produced in the chart on the preceding page and the table above. As disclosed in my last newsletter, my personal goal is to beat the major benchmarks by an average of 10% per year over the long term. While I managed to accomplish this against the major US benchmarks over each of the past two years, I fell a little short of the Canadian benchmark this year (38.7% vs. 35.1% for the index). The S&P/TSX Composite's large weighting of metals/mining stocks that were up 60% was a large headwind for me. I don't currently own any stocks in that sector in the McValue Portfolio. The reason will become clear shortly.

I would also be remiss if I didn't update you on my one pick from last quarter. Hammond Power Systems (TSX: HPS.A) came out with another poor quarter and with what I hope to be the trough of their earnings for this economic cycle. One quarter is practically irrelevant to my investment philosophy as long as the investment thesis hasn't changed – and in Hammond Power`s case it hasn't. Like most value investments, this one may take some time to play out. At present, the stock remains slightly up (2%) from where I bought it ($9.00).

I don't have a specific recommendation for this quarter and will likely refrain from doing so in future editions. However, I am happy to informally discuss specific stocks that intrigue you or to discuss any of my selected current and former holdings that I divulge on the next page.

The Investment Business

I can`t remember where I first read it but I knew that the moment that I did that it was true – *anything that can be sold in the investment industry will be*. Remember that as you speak with your investment advisor when investing your hard-earned savings. As I said in my last newsletter, unless a money manager can beat the benchmark over a period of time there is no reason for them to exist.

I don`t advocate investing your own money unless you have the time, temperament, skill and passion. If you do then by all means - no one will care more about the outcome than you. For most people this isn`t a realistic option. In that case you have two rational choices: (i) finding an advisor that earns their keep by beating the index (after fees) over time or (ii) buying a low-fee index fund.

***Selected* Current Holdings**

Astral Media
Berkshire Hathaway
Equitable Group
Hammond Power
MacDonald Dettwiler
TMX Group

***Selected* Former Holdings**

Home Capital
Nike
Precision Drilling
Royal Bank
Sprott Inc.
Starbucks
TD Bank
Urbana Corp.

A few years ago I took 10% of my portfolio and gave it to one of Canada's best money managers as measured by long-term investment performance – Eric Sprott. I am charged "2 and 20" (annual fee of 2% of assets managed and 20% of all profits over a 0% hurdle). Given that I love to invest and think that I possess the attributes to invest my own money why would I choose to delegate? The answer is that Mr. Sprott and his colleagues possess an expertise in an area that is not currently within my Circle of Competence (metals, mining, oil & gas). I hope that they make a fortune from incentive fees off me.

There are some great money managers out there (and some truly poor ones with a few crooks as well à la Bernie Madoff). Just make sure that yours is one of the good ones. Don't be afraid to ask questions, challenge and think for yourself! Don`t be intimidated by fancy investment terminology or accept sub-par performance over the long-term (minimum 3-5 years absent dreadful short-term performance). Are they "closet indexing" yet charging you a full management fee? As you contemplate where to put your hard earning savings, make sure that you ask the tough questions of your investment advisor(s). A few suggested questions that may help:

1.What are the performance results over the past 3 years (net of all fees and expenses) and how does that compare to the major benchmarks?
2.What is the investment "style" of the manager and is the manager that delivered the performance still there?

…Til the Next Edition

While I can probably write enough for a daily newsletter I think that once a quarter is all of me that most readers can take (some may even say that quarterly is pushing it). I have a growing list of topics for future editions (Circle of Competence, Leverage, Franchises, Compounding, Psychology and Investing) but I would love to hear about topics that are of interest to you.

On a final note, for years Buffett has had a professional editor to review his annual letters and other writings (Carol Loomis of *Fortune* magazine). Well Warren – I've followed your lead and managed to get a truly excellent editor at a rate that would make you jealous (free!) – Thanks Sis.

I wish you all success in the markets in 2010 and beyond!

Best regards,

Michael.

The McValue Portfolio Newsletter

April 2010

Emotion – The Investor's Foe

Friends, I'm depressed. The market continues to rise and I'm all out of *great* ideas (good just doesn't do it for me). My cash position finds me longing for a market correction to bring the valuations on the stocks that I want to own back to attractive levels. I don't know when it will happen or what the "spark" will be (US/China trade tensions, a double-dip recession, PIIGS, North Korea, Israel?) but it will happen sooner or later. I try not to time the market. In fact, I'm convinced that it can't be done successfully. What I do try to do is to keep looking for cheap stocks in great companies while keeping one eye on where the markets are in the fear-greed continuum (we're currently closer to the latter in my opinion). Unfortunately the market's rally over the past year leaves me empty handed when it comes to new ideas.

With this backdrop I thought that I would start to delve into the area of behavioural finance. To succeed as an investor I believe that it is crucial to understand how our emotions can betray us if we let them. While emotions have come in handy to ensure the survival of our species and in everyday life, they are often a liability when it comes to the markets and investing.

Loss Aversion

> "More money has probably been lost by investors holding a stock they really did not want until they could 'at least come out even' than from any other single reason. If to these actual losses are added the profits that might have been made through the proper reinvestment of these funds if such reinvestment had been made when the mistake was first realized, the cost of self-indulgence becomes truly tremendous."
>
> *Common Stocks and Uncommon Profits, Philip Fisher (1958).*

I see this mistake being made over and over again and I have to admit that I am guilty of it from time to time as well. Numerous studies have shown that the pain of a loss is twice as intense as the pleasure of a similar gain. You need to be aware of this blind spot that we all share and fight it. Go back and re-read the quote above. Repeat as needed.

Patience (Temperament)

I recently read Michael Lewis' latest book *(The Big Short)* which tells the compelling story of an eccentric portfolio manager in California who made a bet against the US housing market and made a killing. However his call was early and he looked foolish for several years enduring stinging criticism from his investors, many of whom withdrew their funds. The lesson that I took from this situation is that it is emotionally difficult to be patient in the investment business. There are always exciting new opportunities and a lot of noise coming out of market pundits and Wall Street "experts". There is a reason that Warren prefers to work from the relative solitude of Omaha.

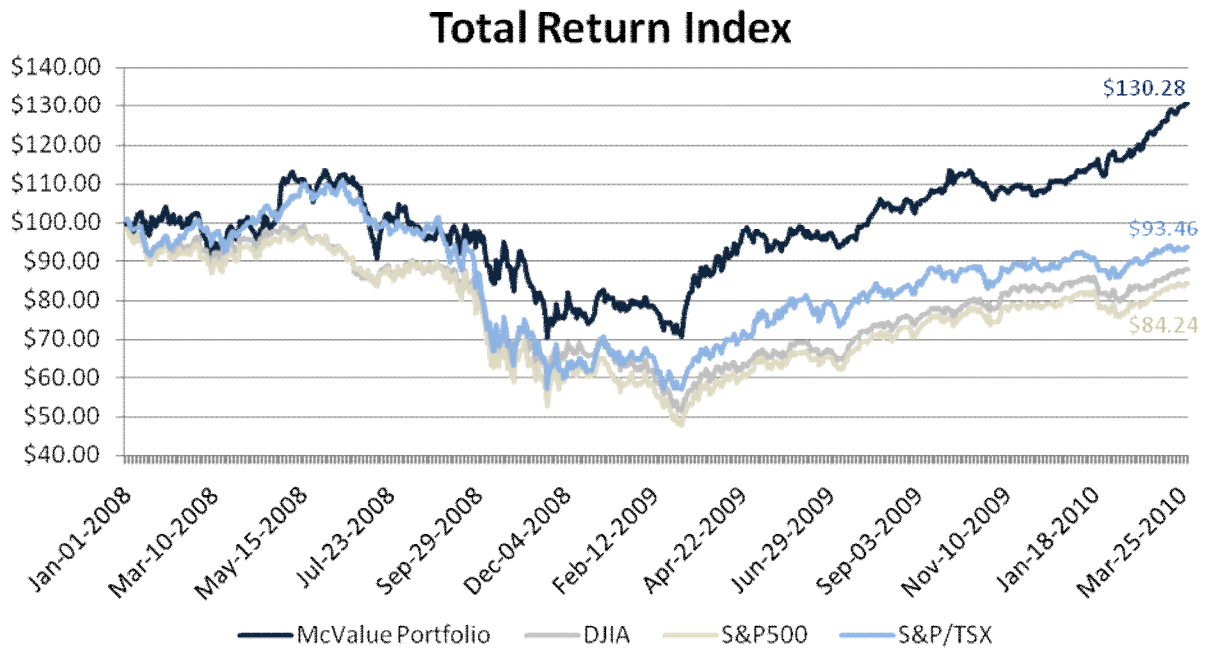
A legendary portfolio manager (Jeremy Grantham of GMO) once said "I would rather lose a client than lose a client's money". Many investment professionals (and I use the term loosely) are too focused on losing clients and succumb to the temptation to mimic the index (also known as closet indexing). To be exceptional in the markets you need to be comfortable looking foolish for a period of time. A very difficult proposition for professional money managers.

Patience is required in the investing game in two respects – First, you need to be comfortable holding cash/treasuries when there is nothing compelling to buy. It is painful as the cash really does burn a hole in your pocket when you see everyone else around you making money and making it look easy. But I would rather give up some potential gains than risk the permanent loss of my capital. Secondly, once a stock price becomes compelling and you buy it, often times the stock continues to decline or stays flat for an excruciatingly long period of time. If your analysis is correct and the value of the stock is significantly higher, resist the temptation to abandon your position. Make the market price your slave and not your guide. A case study on Equitable Group (TSX:ETC) on page 3 should help illustrate both the frustration and the ultimate reward that can come from a value investing approach.

I spend a lot of time doing nothing in the markets. It is hard. But I am convinced that it is one of the keys to making money in the markets long-term and avoiding transaction costs which materially erode returns. Instead, I spend my time reading about different industries and trying to build up my inventory of companies that I would like to own if their stock prices ever become compelling.

A Good Start to 2010

I'm off to a good start this year (+16.79%) with two of my larger positions - Hammond Power Solutions and Berkshire Hathaway up 28% and 24% respectively in Q1 (see McValue Newsletter #1 for my investment rational on HPS.A). Hammond posted a decent quarter and I think that the market is starting to figure out the true earnings power of this cyclical business. In addition to these two stocks, one of my previously undisclosed positions – Grey Horse Corporation (TSX:GHX) - was up 58% for the quarter. I no longer own GHC. As I said in my first letter – I need to keep a few secrets.



	Performance Results				
	McValue Portfolio[1][2]	S&P 500 [2]	McValue Outperformance	S&P/TSX[2]	McValue Outperformance
2008	-19.55%	-37.00%	17.45%	-32.95%	13.40%
2009	38.66%	26.46%	12.19%	35.05%	3.60%
2010 YTD[4]	16.79%	5.73%	11.06%	3.20%	13.59%
Total Return 2008 - 2010[4]	30.28%	-15.76%	46.04%	-6.54%	36.83%
Annual Compounded Return	12.48%	-7.34%	19.81%	-2.96%	15.44%
Standard Deviation[3]	21.37%	22.39%		22.15%	

[1] Based on invested capital (ignoring cash)

[2] With dividends included.

[3] Annualized and based on monthly returns since Jan 1, 2008.

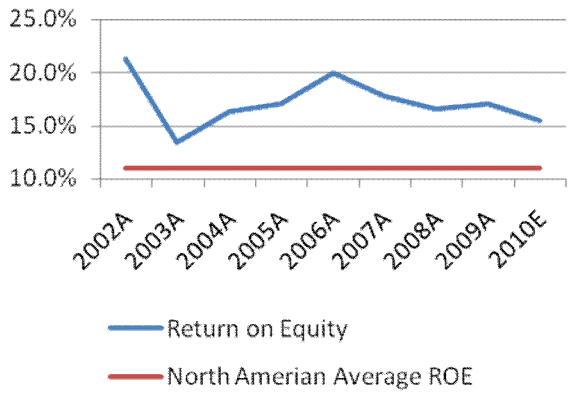
[4] To March 31, 2010.

My updated portfolio results are produced in the chart and table on the preceding page. As you know by now, my personal goal is to beat the major benchmarks by an average of 10% per year over the long term. However, you can't retire on relative performance and beating a market that is down can still leave you worse off than putting your money under a mattress. So, I have decided to come up with an additional goal for myself (call me competitive - you wouldn't be the first). Goal #2 is to earn a 15% compounded annual return over the long term. If that's good enough for Warren and Charlie why should I lower the bar? Goal #1 is still on track but at 12.48% compounded since Jan. 1, 2008 I'm a little short of goal #2. Fortunately I have a few years to catch up to the masters who have managed to beat that benchmark handily.

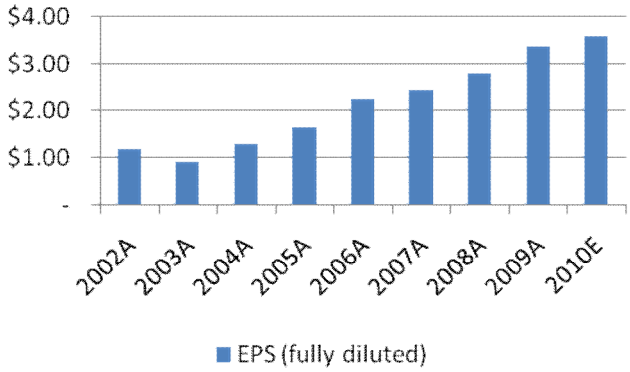
I received some feedback from people that were disappointed that I didn't plan to make specific stock recommendations in the future. Wanting to make this newsletter useful to those that actually take the time to read it, I have decided on a middle ground. Once I add a position to the portfolio I plan to share my rationale for doing so. You can check with your financial advisor to see if my picks make sense for you. On that note, I *insist* that you read the disclaimer at the bottom of the next page.

Equitable Group Inc. (TSX:ETC)

I happen to know a thing or two about the Canadian non-bank mortgage market. So when the financial panic arrived in late 2008 I took notice of ETC as a potential bargain. ETC is a mortgage lender to those that don't qualify for bank credit. They lend against single-family and multi-unit residential properties. They also make some commercial loans.



Is it a good business? Check. Years ago Buffett stated that the average North American business earned about a 11% return on the equity (ROE) invested in the business. Great businesses have higher ROEs and are able to sustain them over time. There is something about these special businesses that prevent competition from eroding their economic franchise. ETC appears to be one of those companies with an average ROE of 17.2% over the past 8 years. They have a deposit-taking licence which I believe is a key part of their above-average ROE. Their earnings per share has increased steadily. Overall it is a business whose future I am comfortable trying to predict.



Am I comfortable with management? Check. Historical loss ratios and reserving have been excellent. Management salaries are reasonable. Chairman (Austin Beutel) is a significant shareholder. Interests are clearly aligned.

Is it cheap? At the time that I was buying it – check. I started buying ETC at $20.75 in Sept. 2008 – right before the market correction. I continued to buy it all the way down making my last purchase in Feb. 2009 at $10.99. My average cost is $16.41. ETC earned $3.36 per share in 2009 – in other words, I started to buy the

***Selected* Current Holdings**

Astral Media
Berkshire Hathaway
Equitable Group
Hammond Power
MacDonald Dettwiler
TMX Group

***Selected* Former Holdings**

Grey Horse Corporation
Home Capital
Nike
Precision Drilling
Royal Bank
Sprott Inc.
Starbucks
TD Bank
Urbana Corp.

stock at around 6x earnings. It proceeded to go much lower so that my final purchase was at about 3.25x earnings. You can imagine my frustration at the time. So what did I do at that point? Basically nothing. I double checked my assumptions (are they going out of business? Is there a risk that they lose their funding? Is there a housing bubble in Canada similar to the US? Did they succumb to lax US style underwriting practices?) I came to the conclusion that I was right and stuck to my guns. My patience was ultimately rewarded.

Since those dark days the economy seems to have turned and ETC appears to be well-positioned to keep growing. Competitors have retreated or gone out of business. I am happy owning it at current prices but you should note that I have not bought the stock above $20.75 (it currently trades at $24.39). It remains my largest position.

What are the Risks? As with any lender, ETC is a leveraged company ($10.28 worth of assets for every $1.00 of equity). I typically avoid companies with a lot of debt but in the case of lenders most of their debt is made up of deposits (think of it as their "inventory" that they mark up and sell). But make no mistake – if they turn out to be a poor lender they will erase *all* the equity in the business very quickly. Losses will spike if more people lose their jobs or if Canada is in a housing bubble. If ETC ever lost its deposit-taking licence they would be in trouble. Like any OSFI-regulated entity there are huge compliance costs and the regulator may restrict your business activities and force you to reduce leverage for a number of reasons. ETC securitizes which accelerates earnings and justifies a lower trading multiple. Shall I go on? (I could).

On top of the business risks, the stock is highly illiquid. You will need to be patient to buy it and to sell it without moving the market price. Again, patience is required.

…Til the Next Edition

If you have any bright ideas please give me a call (collect would be fine). I am currently spending a lot of my spare time upgrading my knowledge of the pharmaceutical industry. This is becoming a major time commitment but given our society's demographics, the recent US Health Care bill and recent changes in certain Canadian provinces I think that there are opportunities here. In fact, I have a specific stock in mind (it looks *really* cheap) but I don't plan to pull the trigger until I better understand the sector. If I do I will share the name with you next quarter.

Enjoy the warmer weather!

Michael.

The McValue Portfolio Newsletter

July 2010

They Will Print

Alan Greenspan wrote a remarkable Op-Ed piece in the Wall Street Journal last month about the U.S. Government's out of control deficit. Here are a few excerpts that I had to read several times to make sure that I read it right:

> *Perceptions of a large U.S. borrowing capacity are misleading... Despite the surge in federal debt, …inflation and long-term interest rates, the symptoms of fiscal excess, have remained remarkably subdued. This is regrettable because it is fostering a sense of complacency that can have dire consequences.*
>
> *The U.S. government can create dollars at will to meet any obligation, and it will doubtless continue to do so.*
>
> *The federal government is currently saddled with commitments for the next three decades that it will be unable to meet in real terms… We cannot grow out of these fiscal pressures. Only politically toxic cuts or rationing of medical care … or significant inflation, can close the deficit.*
>
> U.S. Debt and the Greece Analogy, WSJ June 18, 2010

And there you have it. The creator of the "Greenspan put", the man known for his loose monetary policy as Fed Chairman that contributed to at least two major bubbles, seems to have discovered the value of restraint in his post-Fed life. I agree with all his comments above but what I find remarkable about the article is his level of candour, especially for a past Fed Chairman. You have to give him credit for finally getting it right.

Clearly Mr. Greenspan is saying that the US will print (inflate) their way out of their current mess. Warren Buffett wrote a similar Op-Ed piece in the NY Times about a year ago. Politicians being what they are can do one of three things when faced with unsustainable fiscal deficits: (i) raise taxes, (ii) cut spending or (iii) inflate their way out by printing money. Given that the first two options aren't exactly vote getters and the third option can be done in relative secrecy, which option do you think they will choose?

The economist Herbert Stein came up with a brilliant quote in the 1980s that seems apt: "If something cannot go on forever, it will stop". I am a big believer that the U.S. will eventually get its act together but there will be some pain in the interim. Inflation and a lower U.S. dollar are risks that investors should keep in mind when positioning their portfolios.

The Greenspan and Buffett Op-Eds are both worth reading in their entirety. They can be found by copying the following links and pasting them in to your web browser:

http://online.wsj.com/article/SB10001424052748704198004575310962247772540.html
http://www.nytimes.com/2009/08/19/opinion/19buffett.html

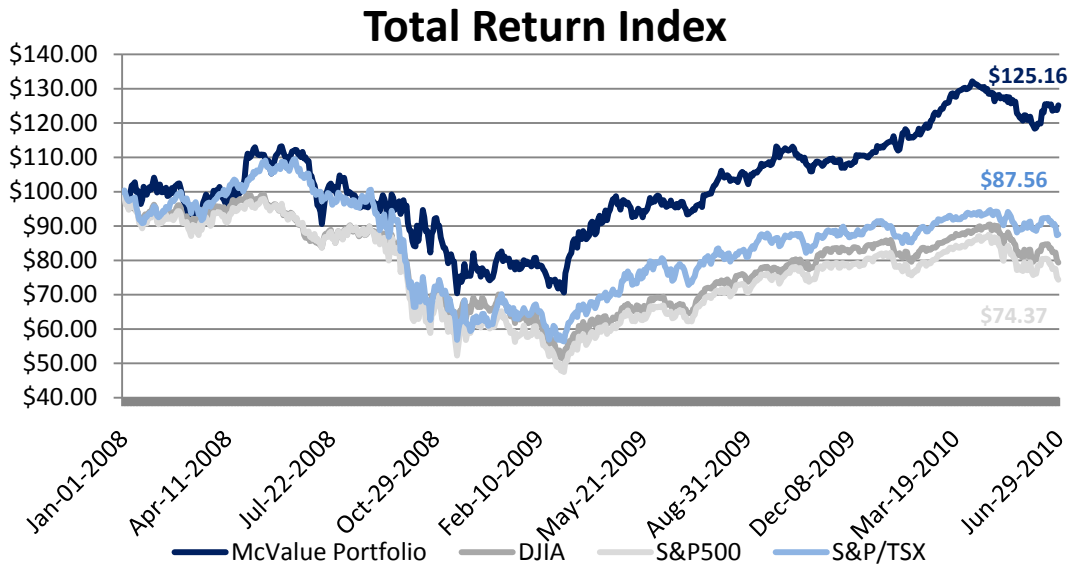
Compounding in Reverse

Fortunately for me I inherited my mother's phobia of debt. It has come in handy the last few years. In light of the discussion above I have a favour to ask of each of you. Please take the time to educate your children on the perils of excessive debt and spending beyond one's means. Teach them about the power of compounding and the benefits of starting to invest early.

I was recently asked to give a presentation at my daughters' school on the topic of investing and the stock market. The presentation is attached and was structured to make the subject fun for kids. On further thought, feel free to pass it along to any politicians that you know as well.

I Should Have Read My Own Newsletter

I gave back about 3.9% of my great start to the year in Q2. My performance was better than the major market indices but lousy nonetheless. I managed to make one smart decision in the quarter when I finally sold my holding of TMX Group at $29.04. I went back to my last newsletter and reread the Philip Fisher quote about holding a stock until you 'just get back to even'. My original thesis on TMX was that its new competitor in Canada (Alpha) would struggle to make much of a dent in TMX's effective monopoly on trading, data and listings. I was wrong. As trading share continued to slip at TMX I justified holding by saying that trading wasn't everything … in fact data and listings are where they really make their money I kept telling myself. Guess where Alpha went next. The urge to justify a past decision, even a poor one, is a strong psychological force. Take it from me.



	Performance Results				
	McValue Portfolio[1][2]	S&P 500 [2]	McValue Outperformance	S&P/TSX[2]	McValue Outperformance
2008	-19.55%	-37.00%	17.45%	-33.47%	13.93%
2009	38.66%	26.46%	12.19%	35.05%	3.60%
2010 YTD[4]	12.20%	-5.00%	17.20%	-2.55%	14.74%
Total Return 2008 - 2010[4]	25.16%	-25.63%	50.79%	-12.44%	37.60%
Annual Compounded Return	9.39%	-11.17%	20.56%	-5.17%	14.57%
Standard Deviation[3]	20.67%	21.94%		21.34%	

[1] Based on invested capital (ignoring cash)

[2] With dividends included.

[3] Annualized and based on monthly returns since Jan 1, 2008.

[4] To June 30, 2010.

I mentioned last quarter that I was digging in to the pharmaceutical industry. I have probably put about 30 – 40 hours of reading under my belt yet I can still only understand about half of what the pharma expert that lives down the street tells me about the space. I hinted that I had a stock in mind that looked *really* cheap. It still does … but only on the surface and I decided *not* to buy it at its current trading price. Sure enough it has rallied despite the tough market conditions. A look at why I passed should help you to understand how I analyze stocks and how I would encourage you to as well.

Forest Laboratories (FRX-NYSE)

What if I told you that you could buy stock in a company with no debt, over $4 billion of cash and marketable securities on its balance sheet, generating over $1 billion of free cash flow a year and trading at a market cap of $7.5 billion? In other words, a mid cap US company trading at about 3.5x free cash flow. Not good enough? OK – what if I added that Forest was founded in 1956, its current CEO has been running the company since 1977, the management team is shareholder friendly (stock buybacks, reasonable compensation), makes decisions based on a long-term view and consistently delivers very high returns on equity and capital without using leverage? I think that you can understand my excitement. So what scared me off?

Patent Cliffs

Forest develops and markets patented pharmaceuticals primarily in the US and Europe. The company is a very effective sales organization and has a distribution channel that is difficult to replicate. However these talented people need products to sell and when I dug deeper I started to see a few leaks in the moat. Patented drugs are huge money makers once they are approved for sale … until the patent expires that is. That's when the hoards of generic pharma companies out there start making bioequivalent products that your pharmacist will usually substitute at the drug counter when you pick up your Rx. When I looked at Forest's licensed drugs I quickly noted that over 85% of their revenue comes from two drugs that are coming off patent in the next few years. That's not good. However, that's not the end of the story. Here's what I did next.

I calculated the cash that Forest would generate from all of its patented and approved drugs over their remaining patent terms and discounted it back at a reasonable rate. I also considered the company's R&D and other operating expenses over the period. Ultimately I came to a value of about $9.00 a share even after covering income taxes. Add that to the $13.50 a share in cash they currently hold and I get to about $22.50. The stock got as low as about $24.00 before rebounding.

Astute readers will recognize the missing part of my analysis so far. What about Forest's drug pipeline? You know, all of those exciting compounds that might be the next blockbuster drug. I thought of that and here is my take on the subject.

***Selected* Current Holdings**

Astral Media
Berkshire Hathaway
Equitable Group
Hammond Power

***Selected* Former Holdings**

Grey Horse Corporation
Home Capital
MacDonald Dettwiler
Nike
Precision Drilling
Royal Bank
Sprott Inc.
Starbucks
TD Bank
TMX Group
Urbana Corp.

Forest has a broad pipeline of potential new drugs in various stages of clinical trials. I'm not a medical expert and don't possess a Ph.D. but I like management's track record of R&D successes and licensing promising compounds from third-parties that want access to Forest's marketing heft in the US (and some of their cash as well). I will give this management team the benefit of the doubt when it comes to allocating capital to new opportunities given their track record.

So why didn't I buy the stock? While I like all of the promise in the drug pipeline, I'm not prepared to pay much (if anything) for it. If I can pay $22.50 and get a "free option" on the pipeline and a major blockbuster, sign me up. If a major breakthrough happens great, if not I'm getting value for my $22.50. That's a decent risk/reward in my book. But above $22.50 there isn't enough of a margin of safety for my liking.

You should note that analysts at some of the leading Wall Street firms continue to tout the stock with $35.00+ price targets based on no more than a multiple of cash flow or EPS. I don't mind their call on the stock, I just question the valuation methodology. It's called the sell-side for a reason.

By the way, the last trade – about $28.50. Let's move on, shall we.

…Til the Next Edition

I promise to keep looking harder but next time I will keep my mouth shut until I actually pull the trigger. Until then, I'm going back to reread my January newsletter about the guy that collected movie posters. It turns out that he was actually on to something.

Michael.

The McValue Portfolio Newsletter

November 2010

I'm Out.

This will be my final edition of the McValue Newsletter and a little more personal than the previous editions for reasons that I set out below.

As most of you know, I recently resigned from my investment banking position that I began nine years ago with Cormark. The smile on my face tells me that taking some time off after 15 years on Bay Street seems to agree with me. I have finally decided that instead of reading Annual Reports and Proxy Statements while on vacation with my family, its time to do this as my full time job. I am therefore proud to announce that I have formed my own investment management company – GreensKeeper Asset Management Inc. Writing this newsletter has helped me to recognize what I really love to do. Thank you for taking the time to read it and provide me with such wonderful feedback. Your encouragement has helped me to make the move.

One of my investment heroes recently remarked:

> *"…the basic idea is that if you want to succeed in life in a capitalistic world, go where the competition is low… A very flawed person like me can do pretty well if he seeks out competition that is inferior."*
>
> *Charlie Munger, Outstanding Investor Digest (Aug. 9, 2010)*

I think that the investment management industry has largely lost its way. Don't get me wrong - there are some very talented managers with decent results and plenty of integrity. Unfortunately they are too few and far between. The industry is rife with closet indexing, excessive and often hidden fees and managers that constantly underperform. It has largely become a sales and marketing game. Given my passion for investor education and through the formation of my own Fund, my goal is to start to remedy some of these industry shortcomings. Remember my lesson from McValue #1 – unless a money manager can beat the benchmark over a period of time (after fees) there is no reason for them to exist.

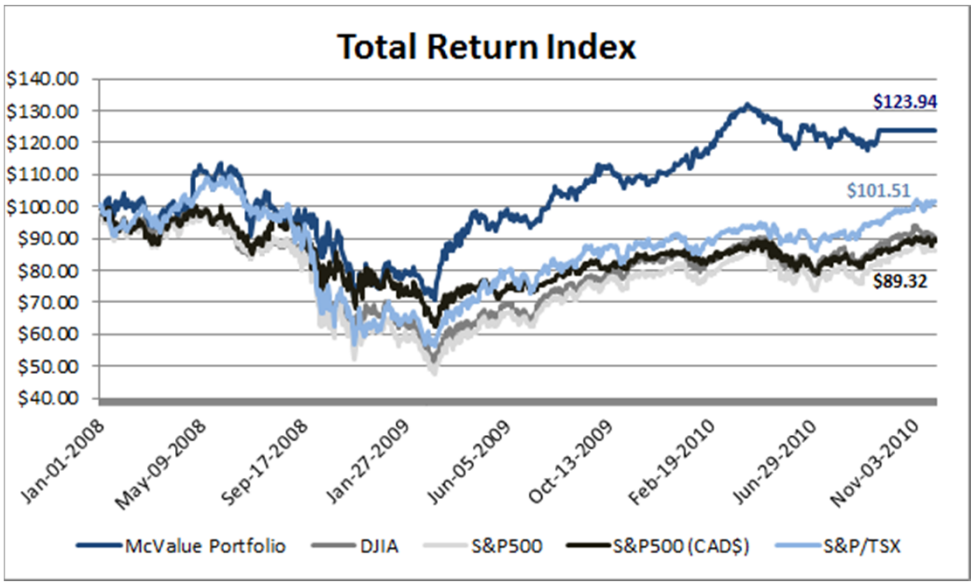
I plan to launch the GreensKeeper Value Fund early in the new year subject to receipt of all necessary regulatory approvals. The Fund will be open to "accredited investors" and others that invest a minimum of $150,000 and I will keep you posted in the coming months. I will most likely be the largest single investor in the Fund from day-one and will have the bulk of my net worth in the Fund alongside my clients. As you know, I believe in eating my own cooking. Let's just say that I will be motivated to focus on the task at hand.

The McValue Portfolio

In light of the foregoing I have liquidated my entire investment portfolio and only hold cash and short maturity Canadian Treasury Bills at the moment. Don't confuse this move as a market call (despite my slightly negative view of current equity valuation levels). This portfolio shift was necessary to allow me to deposit the proceeds in my Fund. Unfortunately my timing was poor. As soon as I went to cash (~Sept. 1) the equity markets have rallied significantly. Overall my move to cash has cost me around 10% in performance over the past three months. There is a lesson here – you can't time the markets or predict their direction in the short term despite the many market pundits that try to suggest otherwise.

My portfolio's performance has lagged the market indices during the third quarter and into the fourth. The timing of my move to cash was the main culprit but I have to admit I have been a little distracted lately. The reality is that one quarter's performance is largely irrelevant (or one year for that matter). What's important is whether you can outperform over several years, cumulatively. Given my current portfolio makeup my performance for 2010 is now set in stone at 11.11%. My relative performance for the year will be determined by how the markets finish the year. I'm keeping my fingers crossed for a major correction before I go shopping for stocks in the new year.

Overall the portfolio is up 23.94% since January 1, 2008 which compares quite favourably with the major indices: S&P500 (-14.07%); S&P500 in $CAD (-10.68%) and S&P/TSX 1.51%. And this was accomplished with lower volatility (less risk according to the academics). If I'm totally honest with myself I have to say that I delivered great relative performance but mediocre absolute performance. I'm looking forward to seeing what I can deliver when I do this full time.



	Performance Results				
	McValue Portfolio[1][2]	S&P 500 [2]	McValue Outperformance	S&P/TSX[2]	McValue Outperformance
2008	-19.55%	-37.00%	17.45%	-33.47%	13.93%
2009	38.66%	26.46%	12.19%	35.05%	3.60%
2010 YTD[4]	11.11%	8.29%	2.82%	12.98%	-1.88%
Total Return 2008 - 2010[4]	23.94%	-14.07%	38.01%	1.51%	22.43%
Annual Compounded Return	7.64%	-5.06%	12.70%	0.52%	7.12%
Standard Deviation[3]	19.34%	21.59%		20.11%	

[1] Based on invested capital (ignoring cash)
[2] With dividends included.
[3] Annualized and based on monthly returns since Jan 1, 2008.
[4] To Nov. 30, 2010.

Protect the Downside

In the presentation that I gave to my daughter's class and distributed with McValue #4 I illustrated the power of compounding. Let's go through a simple exercise that builds on that lesson. I find that the result often surprises people.

Suppose that you start with an investment portfolio of $100,000. You are a savvy investor or have a good financial advisor who puts your money into some successful funds and have gains in each of the first three years that you invest this money. Assume that your portfolio earns 20% in Year 1, 25% in Year 2 and 10% in Year 3 (all returns are after fees). Very good numbers based on historical returns from equities. Year 4 is tougher as it brings a major market correction (think 2008) and your portfolio gives back 40%. How do you think that you've done over that four year period? Most people are surprised to learn that they are actually *down* from where they started ($99,000 to be exact) despite peaking at $165,000 at the end of Year 3. The lesson here is that compounding is a very powerful force (the eighth wonder of the world according to Einstein) however it also works in reverse when you incur losses.

I have a mouse pad on my desk that I picked up in Omaha a few years back with Buffett's cardinal rules of investing inscribed on it. I keep it in such a conspicuous place as a constant reminder of the double-edged sword of compounding:

Rule #1 – Never lose money.

Rule #2 – Never forget Rule #1.

When equity markets are rallying and everyone around you seems to be making money your instincts will tempt you to try and join the party. It is in our nature – a remnant from our primitive instincts formed when we fled predators on the open plains. There is often safety in numbers and in following the crowd. Unfortunately it is exactly the wrong thing to do in the investment business. When everyone loves equities they are priced dear but when panic ensues they are effectively being given away. However, it is painful to sit on the sidelines when everyone around you is having fun. Chuck Prince (former CEO of CitiGroup) gave an interview to the Financial Times of London in July 2007 and said:

> *"When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."*

CitiGroup's equity valuation peaked at $277 billion in 2006. It is now worth approximately $160 billion *less* than that. I'm not sure that CitiGroup made enough money dancing to make up for the destruction of wealth that has ensued. I think that the following quote from the Oracle himself sums it up best:

> *"I will tell you how to become rich. Close the doors. Be fearful when others are greedy. Be greedy when others are fearful."*
>
> *Warren Buffett*

Current Holdings
Cash
Canadian Treasury Bills

***Selected* Former Holdings**
Astral Media
Berkshire Hathaway
Equitable Group
Grey Horse Corporation
Hammond Power
Home Capital
MacDonald Dettwiler
Nike
Precision Drilling
Royal Bank
Sprott Inc.
Starbucks
TD Bank
TMX Group
Urbana Corp.

The New Newsletter

In my time off I have managed to take in a value conference in NYC and to witness first-hand the Hawaii Ironman World Championships. Very inspiring. The picture below gives you a hint at my new website that will launch some time in the new year. I couldn't resist the prospect of some free advertising on NBC. I will send out an announcement once my website (and business) is up and running.

I plan to run the GreensKeeper Value Fund the same way that I have managed my own portfolio over the past three years. I hope that this newsletter has given you a good understanding of my investment philosophy and how I approach stock picking. The only difference is that I will devote much more time to the task.

I will continue to write a quarterly newsletter but under a new name better suited to my new company – The Scorecard. I admit that "McValue" was a little cheesy and I would prefer to avoid any unnecessary litigation with the McDonald's Corporation. I will make sure that you remain on the distribution list for future issues. In the interim I would be happy to discuss stocks, the market in general or my new Fund with any of you if you are interested in doing so.

Wish me luck. Michael.