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.

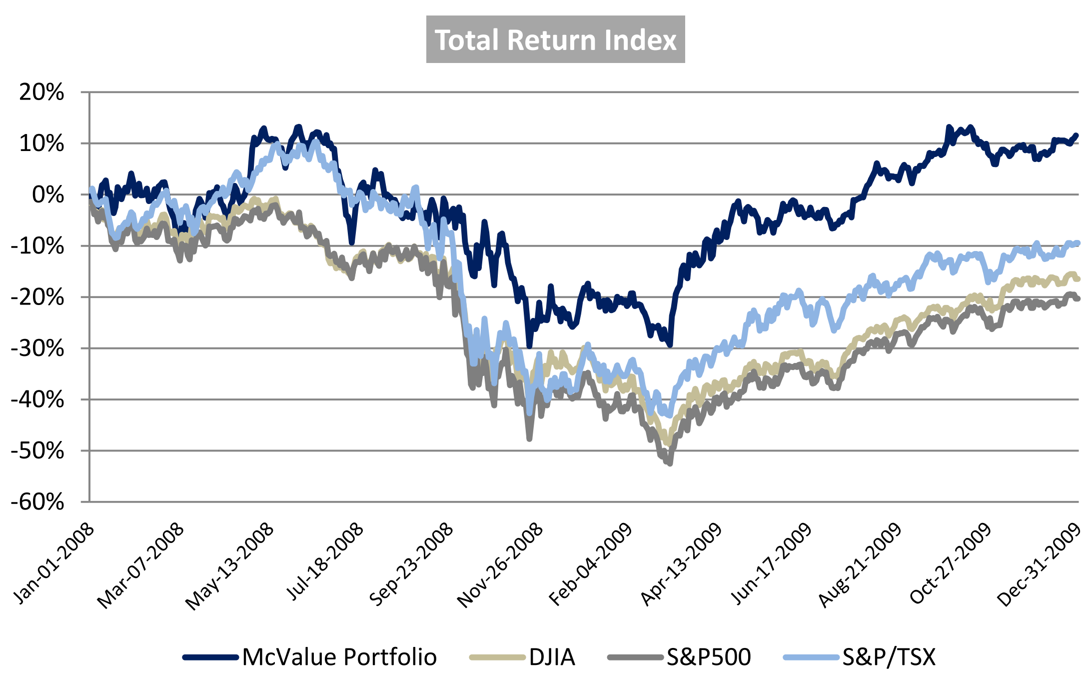
Once you understand this fundamental concept then you should be able to ace this little pop quiz:

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).



	Yearly 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.