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.

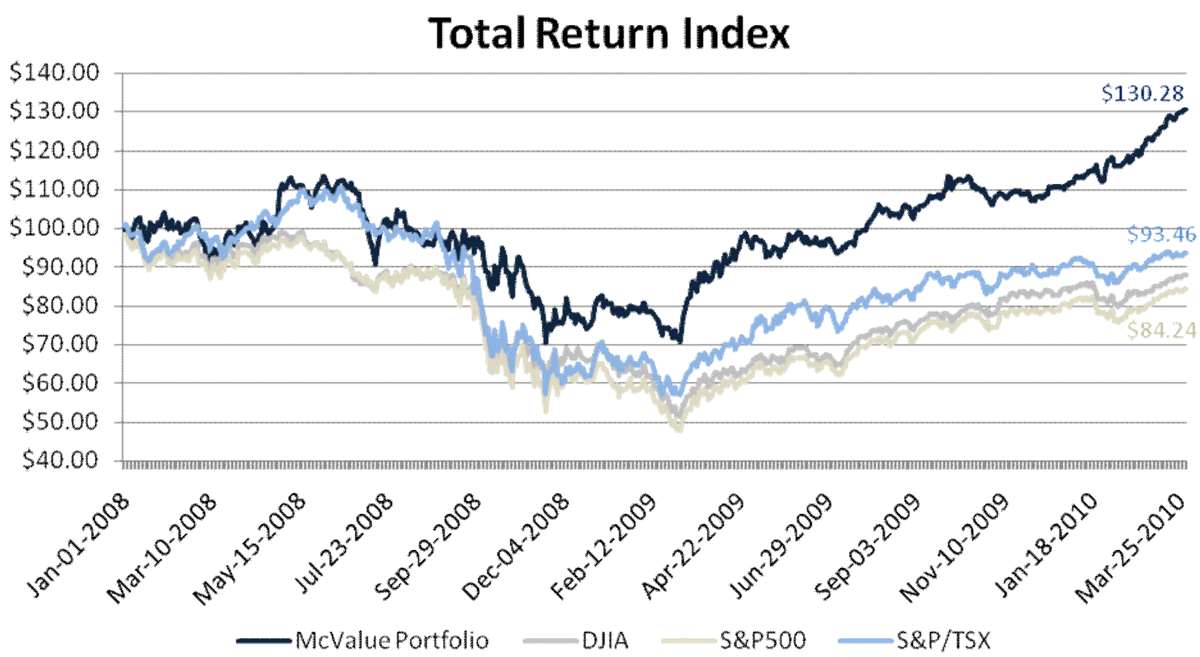
A legendary portfolio manager (Jeremy Grantham of GMO) once said "I would rather lose a client than lose a client's money". Many investment professionals (and I use the term loosely) are too focused on losing clients and succumb to the temptation to mimic the index (also known as closet indexing). To 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.

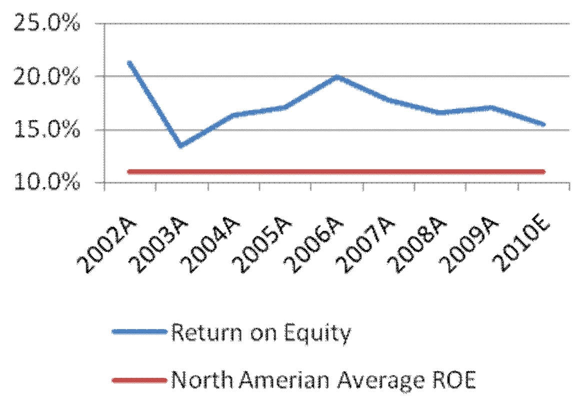
[4] To March 31, 2010.

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.

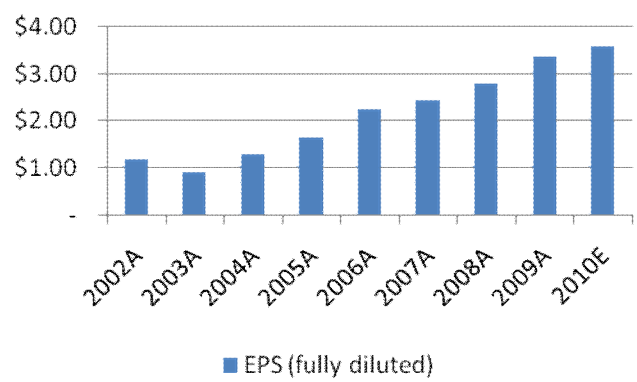
I received some feedback from people that were disappointed that I didn't plan to make specific stock recommendations in the future. Wanting to make this newsletter useful to those that actually take the time to read it, I have decided on a middle ground. Once I add a position to the portfolio I plan 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.