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

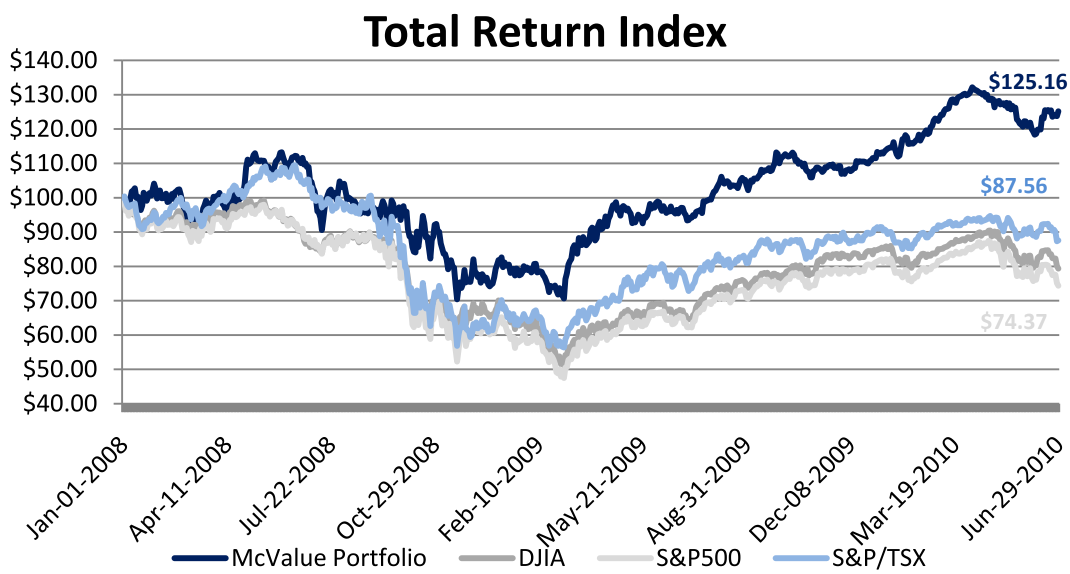
Compounding in Reverse

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.