

**“Bear in mind, Sancho, that one man is no more than another, unless he does more than another.”**

-- Don Quixote de la Mancha

In the novel by Miguel de Cervantes, Don Quixote is a somewhat mad, middle-aged gentleman obsessed with chivalrous ideals. Along with his equally-befuddled partner Sancho, Quixote takes up his lance and sword to defend the helpless and destroy the wicked. In his quest, he is faced with choices between good and evil, recognizing that one must live with one's own conscience around choices made over time.

I'm certainly not as noble (and hopefully not that mad), however; like Quixote, I have learned to live with decisions that haunt my conscience. With this in mind, I've jotted down my varied thoughts in this note.

The actual business of investment management is terrifically engaging. Very few occupations allow one to explore the thoughts of entrepreneurs as they envision the development of their companies, then monitor the deployment of that vision over time. While I've witnessed spectacular success and the occasional breathtaking flameout, common to all is the passion to build a business based on a set of principles and ideals believed to be in the best interests of clients.

One of the more interesting books I've read over the years is Jim Collins' "**Good to Great**". While now a bit dated (it was written in 2001), his research team spent five years attempting to determine what it takes to change a good company into a great one. Not surprisingly, they found change was not initiated by compensation, acquisitions or technology, but by a process rooted in a down-to-earth, long-term, commitment to excellence that kept both leadership

and its people engaged. The process was not revolutionary, but evolutionary – his analogy was of a chicken emerging from a dormant egg that nobody watches. And it was not people that made the difference, it was the right people.

It is simple to be critical of those that have failed and respectful of those achieving success; however, the evaluation of success and failure can largely be a matter of time. Imagine freezing the Kentucky Derby barely half a mile into the race and awarding the horse in the lead at that time with the gold trophy – a preposterous concept, yet the "forecasting of success" goes on every day in the investment business.

### *Short term gratification...*

The management of client money is counterintuitive to the investor mindset. So a profusion of short-term quantitative minutiae is developed, undermining not only investor performance but incubating inefficient and, at times, dangerous decision-making. The lure of needing to quantify short-term success – a normal human condition – has led to irrational measures.

Morgan Housel, journalist for the Wall Street Journal, wrote an interesting article entitled "**If Other Industries Were Like Wall Street**". Just a couple of his tongue-in-cheek comments:

- **If we were as impatient about gardening as we are investing:** Sam plants some seeds in his backyard. He checks back four hours later. Nothing. He digs them up and replants them. Four hours. Still nothing. A week later he is dismayed that he has no oak trees in his backyard. He calls oak trees a scam.
- **If we checked our physical health as much as we check our portfolios:** Ryan wakes up in the morning and checks his blood pressure. He checks it again before breakfast, during breakfast, after breakfast, and before leaving for work. When he gets to work he

checks his cholesterol again before lunch and twice before bedtime. During one of the four times he weighs himself during the day the notices he lost a quarter of a pound. He calls his doctor to find out what the hell is going on.

Of course, finding a great business that others are unaware of (the “egg”, if you will) is a long and tedious process. Understanding the management and vision of a small cap business is not something that happens in a couple of meetings. One cannot dissect the business financials and make simple rationalizations on whether prudent use of capital today is reflective of tomorrow’s growth. In short, it is the long term compilation of data – decisions on capital, engagement and development of people, and a clear vision of purpose – that gives us comfort the chicken will emerge.

### *The lure of the benchmark...*

Over the years the most common, and most difficult, question I’m asked is which benchmark our portfolio should be measured against. In truth, I understand the reason for the question – how does one measure portfolio success both in the past and in the future without having a baseline to do so.

The reality, like CAPM, benchmark measurement should be eliminated; doing so forces one to think about, a) relative valuation of a particular security to the benchmark, b) the relative risk of deviating away from benchmark weights, and c) the relative return which, if you are of the appropriate value mindset, should be a factor of patience and a willingness to be contrarian. In fact, I believe strongly (as do many much smarter than I) that relative benchmarking is used solely for the purpose of making performance analysis simple while undermining the skills of the investment mind. In short, forcing benchmark thinking alters the behaviour of an otherwise intelligent manager.

Unfortunately, benchmark thinking has led to “herding”, a concept that has been discussed and written about by many (including yours truly). Simply put, given the competitive nature of the business to accumulate assets, one is forced to “outperform” not only the relative benchmark, but also peer returns. This leads otherwise intelligent managers to worry about

what other intelligent managers are investing in, and avoid the risk of being seen as “different” and making decisions that might negatively affect their career. Herding has everyone chasing the same stocks, which creates price momentum and leads to valuations well in excess of what would normally be considered fair value. Unfortunately, the fact that the value of a business stretches well into the future is in direct contradiction to the need by many to measure quarterly investment results.

Going one step further, managers espousing tracking error as a concept of performance analysis are focused more on the risk to their career than on client investment. The concept of defining risk as a function of standard deviation or volatility without context is not providing anyone with plausible facts. I have never met an investor that was worried about upside volatility, only potential downside loss.

So too are the institutional concepts of “style drift” or “holdings-based style analysis” or, better yet, “returns-based style analysis”. These concepts, with their roots in the fatally flawed CAPM functions, provide statistical analysis on a manager’s portfolio that really equates to blind faith. Over the years, I’ve had analysts question why my portfolio has taken on “growth” characteristics despite my penchant for value-based investing. When asked to explain their reasoning, the answer is typically rooted in statistical ratios which serve to measure either the past – akin to measuring how successful your driving has been by congratulating yourself that the car is still intact – or the future, which is based on some form of pseudoscientific consensus forecasting by the brokerage community.

In truth, history has shown the concept of “value” has a variety of existential meanings; the basis in fact is that something is purchased for less than what it’s worth. If you were selling something for \$1000 that was purchased for \$500, obviously you are satisfied the item has achieved full value – yet the individual that buys it for what you consider full value obviously believes it’s cheap! It’s that differing perspective that makes our business so interesting, so difficult, and so damnably frustrating at the same time. As Charlie Munger says, ***“It’s not supposed to be easy. Anyone who finds it easy is stupid”.***

## *Gardening...*

Following along with Housel's theme earlier, my very close friend Jacques is a tremendously talented gardener. Jake works very hard at his garden, regularly pruning and weeding to ensure shape and form, adding and removing varieties to balance colour and consistency throughout blooming periods, and nurturing each plant to maximize its potential. Walking through his massive garden throughout the summer is one of life's true joys, yet there are times in the off-season when, to the untrained eye, the garden is a dark and unappealing place.

A portfolio is very much like a garden, and a good portfolio manager like a gardener. It takes time for positions to take root and grow. Short term performance then is counterintuitive. Moreover, a good manager understands that it takes more than just a good selection of stocks to make a great portfolio – how they interact together in both positive and negative environments provides the investor with a "smoother" investment experience.

## *Hedge fund nirvana....*

Which, of course, is the siren song of the hedge fund industry.

There has been much written regarding the collapse of various hedge funds in 2014, largely because their continued underperformance hasn't lived up to their excessive fee structure. While true that hedge funds provided great returns in the 1990's and fared reasonably well in the occasional market meltdowns in the past fifteen years, overall their popularity has been largely driven by strong marketing concepts that have failed to deliver in recent times.

To be truthful, I am not completely opposed to hedge fund concepts though I do have strong feelings that going short on a stock is not really investing but speculation on the overall market emotion relative to the underlying fundamentals of the investment.

What really rankles me is the fee structure; usually a base fee of 1% or 2% on the market value of assets PLUS a share (usually 20-25%) of the profits earned in

the portfolio (known as performance fees). To quote a note from Howard Marks in 2004, "***hedge funds are a compensation system often mistaken for an industry.***"

We believe strongly that the fees Laurus receives should be aligned with our investor interests – just as we believe that capital deployment by the companies in our portfolio should be aligned with shareholder interests. Our clients are charged a reasonable annual fee based on the assets under management – the total revenue of the firm only increases if our assets increase, which will largely be driven by prudent investing over time.

Hedge fund investors seek that perfect nirvana – investment returns with low volatility, substituting the idea that low volatility means lower risk. This "***fallacy of safety***", a term coined by James Montier, is in contravention to the hedge funds' ability to add leverage to the portfolio, thereby exacerbating the return profile of the underlying portfolio. For example, a 5:1 leverage in a hedge fund portfolio will provide an investor with 50% upside return instead of 10% - or 50% loss instead of 10%. The investor's problem is being unaware of the underlying portfolio structure and the applied leverage – a classic "caveat emptor".

## *Oil's well in the market....*

There is no question that investor concerns shifted radically in 2014. As we entered the year, most of the pundits were concerned about potential changes to interest rates – how much and how fast. By the end of the third quarter, most of the chatter centred on the fall in oil prices – again, how much and how fast.

There is a lesson to be learned; consensus over the past year around interest rate increases has been largely wrong – interest rates have largely declined and the Canadian bond market has provided investors with a return of almost 10% compared to a relatively benign equity market return. And now, consensus predicts oil prices to stay around \$60, give-or-take, for the next couple of years.

It may be so - we would be the first to admit that our skill is not in predicting macro events. But years of experience has taught us that oil is a consumer-based

commodity. Prices have fallen primarily due to oversupply during a period of declining demand; high gasoline prices affecting North American consumers, and slowing economies in China and throughout parts of Europe have resulted in increasing inventories.

However, lower oil prices will result in consumers having more money in their wallet (in my little car, lower prices have resulted in a in a tank of gas costing me \$12 less) which will benefit discretionary buying including travel. It will also result in a reduction in capital spending by oil producers, which will lower supply during the same period that consumer demand increases.

We have heard references to the plunge in oil prices as a “black swan” event. This term, coined by Nassim Nicholas Taleb in his 2001 book *“Fooled By Randomness”*, refers to the author’s idea of a trinity event – rarity, extreme impact, and retrospective (though not prospective) predictability. Since a fall in oil prices is not rare (major decreases have occurred three times in the past six years), we suggest this claim is bogus.

The current OPEC environment is similar to what occurred in the 1980’s. Early in the decade, Saudi Arabia had warned that excessively high oil prices would impact demand. OPEC attempted to stabilize prices by setting lower production quota’s. However, by 1985, Saudi Arabia had tired of this role and almost tripled their production output, driving oil prices down to below \$10 a barrel by mid-1986 and remained low until the Gulf War in 1990.

We can look back at this time to give us some reference to what is transpiring today – but the world, as we all know, is a very different place. Oil prices did not peak at \$40 but over \$100 in the past couple of years. China’s ongoing economic development has had a significant impact on all global commodities, including oil.

We do, however, see opportunity. Normally, our portfolios would not have excessive holdings in commodity-based oil producers as cash flow is largely plowed back into the ground to rebuild ever-declining reserves rather than building wealth for shareholders.

Nevertheless, there are occasional opportunities – like today – where the very highest quality producers have had their stock prices decimated alongside the lowest quality businesses. The excessive fear that pervades the market in times like this provides an opportunity for astute investors with a long horizon to acquire positions that will pay handsomely.

In short, the market is now under-valuing many well-run oil producers. That is an opportunity that should not be passed up.

I am fortunate to have found excellent partners to share the passion involved in building a new investment firm. Investors in Canada are not early adopters, and do not readily invest with new firms like Laurus despite considerable experience. And so, collectively, we are very fortunate and we greatly value our clients. We appreciate their confidence in us, and look forward to exceeding their expectations in the future.

Christopher (Chris) Page  
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