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MONTHLY UPDATE
10
2014

“The four most dangerous words in investing are: 'this time it's different.'”

-- Sir John Templeton

In his book *"The Most Important Thing"* Howard Marks opines that there is far too much randomness in the world for the future to be predictable. So, as we gradually pull away from the recent market correction on the back of better than expected earnings results, it is worth reflecting on this thought and how it relates to our topic this month — risk.

Volatility and risk are different. Unfortunately, investors and academics alike get the two confused. There are plenty of mathematical ways to quantify volatility — beta, correlation ratio, standard deviation, value at risk, just to name a few — but none of these quite address the primary fear of investors: *permanent loss of capital*.

Risk is not quantifiable in advance of the gamble – it’s related to the danger we accept in our process of generating an investment return. For example, it’s very easy to meet someone at a cocktail party bragging about the return he or she has made on their investments. It’s less easy to understand the gamble taken to achieve that return. What actually happened is only one possible outcome of a variety of outcomes ranging between investment success and calamity.

Of course, the wise investor can skew the probabilities toward success. Although risk only exists in the future, through extensive fundamental analysis one can determine the probabilities of an investment achieving a certain return. By determining which assumptions achieve the most probable outcome, one can determine the likely fundamental, or *intrinsic*, value of an investment to assess whether it is worth taking on the risk of investing (after all, why would one risk hard-earned money if not to create wealth).

Beyond the risk of a specific investment, there is also market risk. Attempting to accurately predict the pendulum-like trends of the market on a consistent basis is impossible. With instantaneous transmission of information, “informed” decisions are reached quickly – though seldom correctly.

Of course, that does not stop the constant stream of prognostications from those that are “informed”.

A recent Barron’s article entitled *"The Timeless Allure of Stock-Market Timers"* spoke to the long list of market pundits regularly attempting to predict, with some degree of confidence, the general direction of the market. Certainly asset allocation is a key risk management mechanism to any long-term investor though, as we’ve argued here before, allocation should be based on the liability requirements of the investor and not on some expectation of market trends. The article goes on to contend that humans hate randomness and the idea they lack control and, therefore, they seek those that appear to have conviction.

To that end, there are quite a few “perma-bears” that are regularly quoted in the media. These individuals are negative about markets regardless of what direction they’re taking, and typically hold very high levels of cash for very long periods of time. Fashioning themselves as a “value investor”, the perma-bear will argue that stock prices are continuously overvalued and they are waiting for the next correction to find lower entry levels. Unfortunately, with those we’ve looked at internally, there never is an entry point — even

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coming out of the great recession of 2008, many perma-bears remained on the sidelines through the past five year bull market.

Not that missing a bull market is a risk per se, but its opportunity cost to the investor. With the small exception of the very rich, most investors have limited time to accumulate enough wealth to meet whatever requirement they have in the future. Having their investment manager sit on the sidelines for three, four, five, or more years during an up cycle could lead to taking on greater investment risk to meet future objectives. We — that is, investment managers — are given the responsibility of prudently investing our clients' capital. To quote Laurus' Linda Lebrun, "if you're holding cash for long periods and not deploying capital, there's something wrong with the way you're valuing potential investments." It takes considerable conviction to take on a new investment when consensus is generally negative (conversely, of course, it takes considerable nerve *not* to be buying when everyone thinks the world is rosy). Having a strong sense of the intrinsic value of the investment certainly helps. Being knowledgeable of market excesses from past cycles and prudently acting when extreme negativity creates value also minimizes risk.

As we head towards year end with, hopefully, higher prices ahead of us, opportunities may become fewer again. In the meantime, thanks to the recent correction we are finding certain investments trading below their intrinsic value. These purchases will help lower the overall risk of our portfolio.

Performance

A number of our readers have asked us to provide comments on performance, so this month we will begin offering a very short analysis.

October saw the Canadian exchanges hard hit due to their heavy commodity weights. The TSX Energy sector fell almost 11% in the month as supply continues to exceed demand. The Diversified Metals & Mining sub-index fell almost 14% on fears of a slowing Chinese economy. The combination of these two pushed the larger S&P/TSX Composite down -2.1% and the smaller S&P/TSX Small Cap Index down -8.3% (the latter having a much larger commodity weighting).

Relatively, the Laurus Enterprise Fund fared well, down -0.6% in October. The fact that we do not own any securities in the metals and mining sub-index was a positive, as was our limited weighting in oil producers. However, the very high quality oil service companies we hold fell significantly on the expectation that drilling production will slow in future months.

As we look forward through year end, despite the headwinds created by commodity pressure, there are positive earnings results currently being reported for the past quarter. Valuations continue to be lofty as the market rally over the past couple of years has been a result of multiple expansion rather than earnings growth. Our primary worry remains the sustainability of these valuations, should economic growth begin to wane.