Laurus MONTHLY UPDATE

06 2015

"If you examine returns from the broad stock market indexes over the past one hundred years, it is pretty clear that stocks do better than virtually all other easily accessible asset classes."

-- Monish Pabrai

Over the past few months, there has been a tremendous amount of fear in the markets. Falling oil prices impacting the Canadian economy, the ongoing Greek tragedy, potential rate increases from the US Federal Reserve, the declining Chinese economy, the spiking US greenback and declining corporate profits – whew, makes me nervous just writing these notes.

Why stocks rise and fall is one of the fundamental questions of finance. Obviously, if one were solely concerned about return of capital the logical place to invest would be in investment grade bonds. Stocks carry a lot of perceived risk (volatility) which concerns the average investor – after all, capital need at a given time might coincide with the stock market being at a low point. Truly, as prices rise through investor enthusiasm (the influence of greed), there is greater potential for loss as prices correct (the influence of fear).

This cycle assumes existing market prices incorporate and reflect all relevant information (known more commonly as an efficient market). But what if there was an idea out there that is not yet perceived, appreciated, or well understood?

Investing ideas come in many forms. Certainly market factors play a dominant role; valuation, sentiment, momentum, capitalization, new financings, mergers, acquisitions, spinoffs, etc. all create ideas that are parlayed into investment actions, particularly by the sell-side. Changes in government policy, cultural changes, or other top-down macro ideas also generate ideas for discussion.

More than the macro factors, at Laurus we focus our attention on durable competitive advantage; control of technology, marketing, or other corporate practices that set a particular company apart from its peers. And the smaller the company is, the less likely the idea has been discovered and become common knowledge. That creates an opportunity.

In his early days of modern investing, Ben Graham was teaching at Columbia University and very few in the investing public followed his ideas – they were still reeling from the effects of the Great Depression. As a result, many companies traded for less than the value of their current assets minus their total liabilities. However, as his fame grew, more of his followers acquired these undervalued businesses until, by the late 60's, very few such opportunities were left. Along came Warren Buffett and the building of Berkshire, with he and Charlie Munger touting their own version of "margin of safety" value investing principles.

The phenomenal returns generated by Graham and Buffett came from recognizing an investment idea that the rest of the investing public had yet to see. As the market became more efficient over the past couple of decades, these returns, for the most part, can't be repeated – at least in those businesses that are being followed by the majority of market participants where it is nearly impossible to gain an edge.

Which is why we invest in companies that are under-followed and have a strong competitive advantage. We call these companies "tomorrow's blue chip leaders" because their management and financial strength emulates the best large capitalization companies so closely followed by the market. But, since they are smaller in capitalization, the sell-side sees little opportunity to derive fees and, for the most part, neglects them despite their future potential returns for investors.

Whether valuations are, or are not, excessive is a matter for conjecture. Certainly decelerating Chinese economic growth will impact industrial commodity prices negatively and the expected Fed rate increase will have a negative impact on the markets, at least initially. Regardless of the cycle of fear and greed, over the long term the highest investment gains will be derived from industry leadership that is under-followed.

Performance to June 30, 2015*

	YTD	Two Years	Three Years	Four Years
Portfolio	5.3%	16.7%	16.0%	13.8%
S&P/TSX Composite	0.9%	12.8%	11.1%	5.3%
TSX Small Cap Index	1.3%	6.7%	4.1%	-2.4%

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