My investing journey (and what I learned to forget along the way)

By Andrew Pastor, portfolio manager

> *"Of my fifty-seven years, I have applied at least thirty to forgetting most of what I have learned or read."*
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> - Emanuel Lasker, world chess champion

In high school I had a math teacher whom I will call "Mr. S." He would start every class by displaying a chess puzzle on the whiteboard. Students would get extra credits if they could solve the problem.

I was a chess novice at the time, but couldn't resist a good challenge. I spent the next year studying the classical games so I could understand the foundational principles in chess.

After learning the big ideas, my game improved rapidly and I qualified for Mr. S's chess team. In my last year of high school, I quit varsity basketball to focus exclusively on chess (I wouldn't recommend this if you want a prom date).

Eventually, my progress hit a wall. I started losing just as many games as I was winning. It took me a while to realize that my opponents grasped the same strategies that I did. I had no competitive edge.

I discovered that the only way for me to improve was to "unlearn" some of the core principles. For example, I sometimes let my opponent control the centre so that I could counterattack from the flank. It was only after I "broke the rules" that I made a breakthrough in my game.

In this commentary, I'm going discuss my personal investment journey and share some of the investing lessons that I eventually had to forget.

My lightbulb moment

Eleven years ago I had a meeting that changed my life. It was in the middle of the financial crisis and I was a young associate working at a bank's private client group. Due to the state of the market, I went into work every day, sat at my desk and stared at the stock quotes.

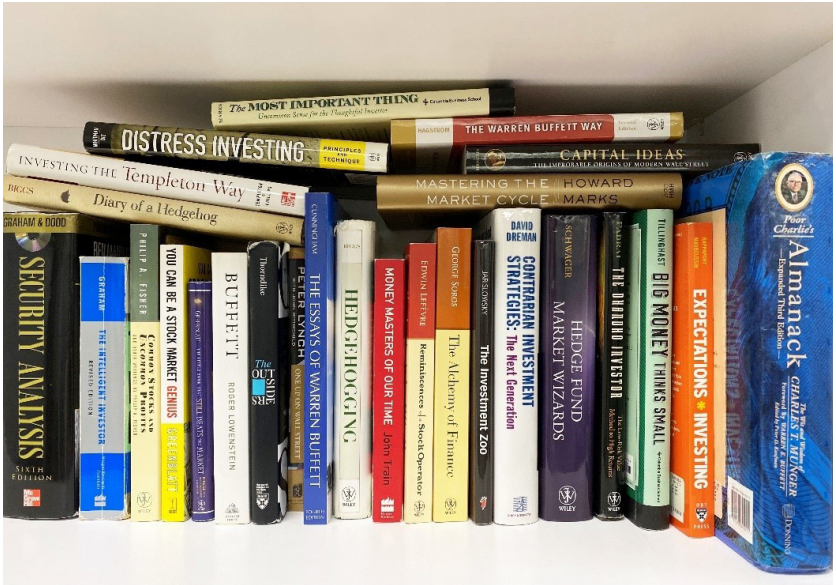
On one particular morning, a bank executive asked me to join him for a lunch. When I arrived at the table, I was greeted by a mystery guest. Before I could get his name, he started asking me questions about the stock market. Embarrassingly, I told him that there was no point buying stocks because they only go down in value. I was in the middle of my CFA studies and I think I even talked about beta and standard deviation.

After patiently letting me ramble on, the guest finally cut me off. He told me I was foolish not to be investing in stocks right now and proceeded to give me a master class on investing. He introduced me to Warren Buffett and Benjamin Graham and left me with three books to read.

Up until this point, I thought the stock market was more like a casino rather than a collection of businesses. I went home that weekend, read the recommended books and fell in love with investing.

Side note: *Years later I discovered that the mystery lunch guest was one of Canada's greatest investors. Unfortunately, he recently passed away and I never got a chance to see him again and say thank you.*

I spent the next several years reading every investing book I could find. My library quickly filled up with many of the investment classics.



Actual photo of Andrew's bookshelf

I could write many commentaries about all the important lessons I learned from my investing heroes, but for the rest of this commentary I'll focus on the ones that I had to unlearn.

Lesson 1 - Reversion to the mean

One of the first investing books I read was *Security Analysis* by Benjamin Graham and David Dodd, considered to be the value investing bible. The following quote appears at the front of the book:

> *"Many shall be restored that now are fallen and many shall fall that now are in honor."*
>
> - Horace

One of the most important concepts in value investing is the idea of reversion to the mean. The idea is that businesses that generate high returns on capital have a target on their back. Capitalism ensures that any excess profits will get competed away. Conversely, underperforming businesses will eventually stop destroying capital and will typically revert towards the corporate average.

As a newly minted Graham & Dodd investor, I spent my early years searching for stocks that had fallen on hard times. I generally ignored dominant businesses because I figured their competitive position would be fleeting. This left me with an investment universe of businesses that were either cyclical, had too much leverage or faced structural challenges (sometimes all three at the same time!).

Over time, I noticed that many great businesses didn't actually lose their edge. There was something structural about their advantages that meant even the best-capitalized competitors couldn't encroach them. By ignoring these great businesses, I was missing out on many incredible investing opportunities.

I later came across a Credit Suisse empirical study that analyzed hundreds of global businesses over a 28-year period (1985 to 2013).[i] It turns out that a good business will remain good 79% of the time. On the other hand, weaker businesses remain below average 83% of the time. So much for the concept of mean reversion!

Across EdgePoint Portfolios, we own some wonderful businesses (examples include Eurofins Scientific, Middleby Corp. and Restaurant Brands International Inc.) that defied economic gravity and continue to generate above average returns on capital.

Lesson 1 unlearned *- Businesses don't always revert to the mean.*

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Lesson 2 - Price is your margin of safety

As a young investment analyst, I was thrilled when I got the chance to attend an investing seminar at Columbia University. Columbia is the home of value investing; Ben Graham was an adjunct professor and Warren Buffett was his student in the 1950s. For the past few decades, legendary professor Bruce Greenwald has carried the university's value investing torch. He started the seminar by proclaiming:

> *"Value investing is about buying the diseased stocks that are beaten down in price…Growth investing is the unsafe sex of the investment process."*

When people think about value investing, they often think about stocks that show up in the 52-week lows, trade at low multiples of book value and whose earnings and have plenty of "hair" on them. The truth is that value investing is a much wider tent.

When I joined EdgePoint, the first company I looked at was Constellation Software. The stock was trading at an all-time high and had already increased six-fold in the previous seven years. This was hardly a "diseased stock"!

After analyzing the business and meeting the company's CEO, we believed that the business was misunderstood. Investors focused on the company's existing software portfolio and didn't give them enough credit for their ability to deploy significant amounts of capital to value-creating acquisitions. That's a fancy way of saying we thought the business was still undervalued.

Why do growth stocks like Constellation Software get ignored by Graham & Dodd investors?

Many traditional investors rely on valuation rules of thumb. For example, buying a business at 10x earnings is considered cheap, 15x earnings is fair and 20x earnings is expensive. In Security Analysis, Ben Graham says that investing in any stock that trades at more than 20x earnings is "speculation," not "investing."

The problem with using multiples to compare companies is that no two businesses are the same. A business that generates high returns on capital and has a long runway for growth shouldn't trade at the same multiple as a business in a commodity industry that generates poor returns on capital. I think most people would agree that buying Amazon at 20x earnings is more of a "value" investment than buying Sears at 10x earnings.

At EdgePoint, we don't think about businesses in terms of P/E multiples. Our job is to figure out a business's future worth and compare that to today's price.

Price-to-earnings (P/E) ratio: the ratio of a company's share price to its estimated future earnings per share.

Here's a snapshot of 12 holdings in EdgePoint Global Portfolio ranked by each company's P/E ratio.[ii] As you can see, we own businesses throughout the spectrum.

Example of 12 holdings in EdgePoint Global Portfolio by P/E ratio

Source: FactSet Research Systems Inc.

Does that make us value investors or growth investors? We think the distinction is meaningless. We look for businesses that can be bigger in the future (growth) and want to buy them without having to pay for that growth (value).

A post mortem

I recently reviewed my mistakes over the past decade and found they all had the same cause: I focused too much on valuation and overlooked the potential for growth.

In 2013, I looked at Boyd Group Income Fund, North America's largest automotive collision shop. It had attractive economics and a long runway for growth since it had less than 1% market share. While I liked the business, I couldn't get comfortable with the valuation so I decided to wait for a better entry point. The stock was trading at $23 back then and it's now over $200. I'm still waiting!

Around the same time, I looked at Dundee Corp., a company we bought in EdgePoint Canadian Portfolio. Dundee is a holding company with disparate assets (mining, agriculture, wealth management, etc.). Despite being a lower quality business than Boyd, I couldn't resist buying the business at a price below its liquidation value at the time.

I couldn't have been more wrong. Boyd executed brilliantly and the company's intrinsic value grew at a nice clip. Dundee continued to destroy value and eventually my margin of safety evaporated. Ignoring growth proved to be a costly mistake.

Lesson 2 unlearned - *Growth (and not just price) can be your margin of safety.*

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Lesson 3 - Averaging down

"Lowest average cost wins."
- Bill Miller

Value investors love to tell stories about how they bought a stock at $10, it subsequently fell to $7 and they bought more, it then continued to drop to $5 and they bought even more. The stock eventually went to $15 and they made a fortune!

While averaging down on an investment can be profitable, I think it's dangerous to just focus on lowering your average cost. Sometimes, "averaging up" on an investment can be a better use of capital.

Early in my career, I found myself anchored to the initial price when looking at a stock. It took me years to realize that the price you (or someone else) paid for a stock in the past tells you nothing about whether it will continue to be a good investment in the future. The only thing that matters is the price you're paying today relative to the business's future worth.

There are many good reasons why you should be willing to average up on an investment: the intrinsic value of the business can grow faster than the stock price; the business could become less risky as the business model is proven out; you might also gain more confidence in the company's management team.

Sometimes the best decision you can make is to buy more of a business you already own, at a higher price.

Let's take a look at the stock chart of Constellation Software, Inc. over the past seven years. We bought our initial position at $123 in EdgePoint Canadian Portfolio. As we got more comfortable with the company, we bought more shares at $450. We continued to add to our position at higher prices (most recently at $925).

Constellation Software, Inc. stock price
Jan. 1, 2013 to Dec. 31, 2019

Source: FactSet Research Systems Inc.

Our unitholders are better off because we didn't get anchored to our initial purchase price, recognizing instead that there was more growth to come.

***Lesson 3 unlearned** - Sometimes buying high is a wise approach.*

Lesson 4 - Avoid turnarounds

> *"Both our operating and investment experience cause us to conclude that 'turn-arounds' seldom turn."*
> *- Warren Buffett*

As a general rule, turnarounds seldom work out. The investing graveyard is filled with people who invested billions of dollars trying to rescue failed retailers.

However, there is a group of turnarounds that have thrived. If you can identify what makes a successful turnaround, it can be an attractive investment opportunity.

What makes a successful turnaround? We're looking for businesses where the core franchise is healthy but the previous management team made an operational or strategic misstep. These tend to be businesses with good underlying economics that operate in growing industries.

Let's walk through an example. Our largest position in EdgePoint Canadian Portfolio is Element Fleet Management Corp. Fleet management is a good business because they provide a mission critical service to their customers. As the largest player in the industry, Element has significant scale advantages.

The previous management team focused on growth by acquisitions. When they tried to integrate their two major platforms, the business ran into trouble. They had a series of operational issues and started losing customers.

In May 2018, the company brought in a new CEO with significant turnaround experience and also restructured the Board. While it's still in the early days, the new leadership has done a remarkable job stabilizing the business and positioning the company for growth.

Turnarounds have become a fruitful hunting ground for our investment team. Examples of other businesses in our Portfolios that we believe have great turnaround potential include Shiseido, CSX, Aramark, Uni-Select and AutoCanada.

Lesson 4 unlearned - *Turnarounds can be attractive investments.*

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Lesson 5 - Concentrated portfolios

> *"Diversification is protection against ignorance. It makes little sense if you know what you are doing."*
> *- Warren Buffett*

Charlie Munger, well-known investor and business partner to Warren Buffett, famously said that all you need is three stocks to be adequately diversified.

While that may be true for them, I've come to realize that diversification is our protection against not being Warren Buffett or Charlie Munger.

Over the past couple of decades, I observed some of the brightest investment minds stumble because they ran highly concentrated portfolios. Multi-decade track records of pleasing returns were erased with a single mistake.

We refer to this internally as the danger of betting on a single idea. This can happen when an investor makes a very large sector bet or is overly exposed to a single investment.

For example, there were some famous investors who loaded up on U.S. banks and insurers just before the financial crisis. While their portfolios may not have appeared to be overly concentrated, it turned out that the performance of almost all financials were correlated during the credit crisis. If you were wrong on one position you were likely to be wrong on virtually all of them.

We saw a similar phenomenon in Canada when some star managers struggled after the commodity super cycle ended.

More recently, some very astute investors made large concentrated bets on an individual stock that went awry. They held 20% or even 30% of their portfolio in a company that was known at the time as Valeant Pharmaceuticals.

You may think that I'm cherry picking. Let's use Warren Buffett, the world's greatest stock picker, as an example of how difficult it is to predict the future.

In the 1996 Berkshire Hathaway annual letter, Buffett described a couple of his largest investments as "Inevitables." The idea was that these businesses would almost inevitably dominate their industries and become much bigger in the future.

> "Companies such as Coca-Cola and Gillette might well be labeled "The Inevitables." Forecasters may differ a bit in their predictions of exactly how much soft drink or shaving-equipment business these companies will be doing in ten or twenty years…In the end, however, no sensible observer - not even these companies' most vigorous competitors, assuming they are assessing the matter honestly - questions that Coke and Gillette will dominate their fields worldwide for an investment lifetime. Indeed, their dominance will probably strengthen."

While Buffett's line of reasoning may have held up for a while, soda sales have stagnated and Gillette's market position has weakened as a result of new competitors.

At EdgePoint, you have heard us talk about the importance of diversifying by business idea. This means owning a group of businesses whose future isn't correlated on each other. Whether Shiseido sells more cosmetics in the future shouldn't be correlated to the insurance pricing at Berkshire Hathaway or pumps and valve maintenance at Flowserve.

In the EdgePoint Global Portfolio, we own a collection of 35 businesses. There's a handful of businesses whose competitive position will likely erode over our holding period. We just don't know which ones they are. But if we do our job right and diversify by business idea, the growth of the rest of the portfolio should more than offset the inevitable mistakes.

Lesson 5 unlearned - *Diversify by business idea and avoid over-concentration.*

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The big takeaway

The time-honoured principles that I addressed above remain valuable rules of thumb for investors, but sometimes you need to break the rules. If you can stay flexible in your approach to investing, you may be able to uncover attractive opportunities that you otherwise might have missed.

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[i] The businesses were divided into quartiles based on their return on invested capital (a measure of business quality). They looked at the same businesses five years later to see if anything had changed.

[ii] 2021 earnings per share estimates used in P/E calculation for EdgePoint Global Portfolio holdings.

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