October 2014

> ***"Progress isn't made by early risers. It's made by lazy men trying to find easier ways to do something."***
> -Robert A. Heinlein

Information is not Knowledge

A friend of mine who works in the investment business mentioned to me recently that the internet had changed investing. Everyone now has access, more or less, to the exact same information at virtually the same time. Any investor can pop open their discount brokerage account online and easily trade all day long, while being fed the same steady stream of economic and corporate news as an analyst from Goldman Sachs.

I reflected on this recently, when I received a phone call from a journalist asking what I thought about Alcoa (one of our firm's investments) immediately following its earnings release. He was incredulous when I answered that I had not yet even read the news flash, but planned to read the company's quarterly filing that evening. With the stock price having already reacted to the headline news, reading a lengthy legal filing several hours later seemed all but a waste of time to him. The headline numbers looked positive – "are you buying or selling?" he asked. I told him that we had started accumulating shares of Alcoa in 2011 when they were trading just under $9, a time when the sector was highly out of favour with Wall Street analysts, none of whom had a "Buy" rating on the stock.

I explained that our investment rationale was that aluminum prices were at a cyclical low and, because of its properties, aluminum was a growth metal. While aluminum prices could always go lower, Alcoa was uniquely positioned as a low-cost producer, owned high quality assets, boasted a strong balance sheet and was trading at a price below the breakup value of the company. With environmental standards getting stricter, every new generation of planes and vehicles is getting lighter in order to burn less fuel. Aluminum, being lighter than steel, is the best alternative, and Alcoa is poised to benefit. When we made our investment several years ago, we had no idea whether the share price would rise the next day, next month or next year. However, at such a compelling price, the shares offered significant upside and a comfortable margin of safety. For a variety of reasons, including increased aluminum demand by U.S. automakers, aluminum prices should rise and, as the aluminum cycle turns, Alcoa's earnings could increase substantially over the next several years.

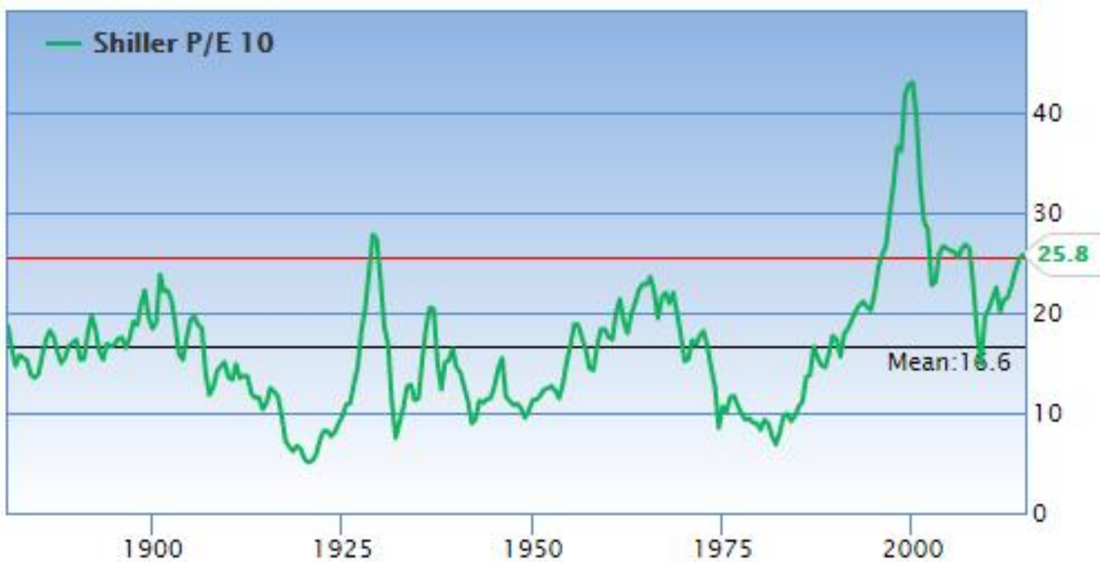
The short-term noise of whether the next quarterly earnings are above or below expectations by a penny or two has no bearing on our decision to hold Alcoa's shares. We always take a long-term view and Alcoa represents a good example of the kind of investment we look for; that is, a company that is financially sound, has a successful track record in its industry and whose shares are trading at a compellingly cheap price. When we find a company with such qualities, we are happy to buy and hold its shares, add to our position if they get cheaper still, and patiently sit with our investment until its full value is realized.

In this world of information overload, we do not need to read every research report or watch every interview on CNBC before making an investment decision. In fact, our time is much better spent sifting through a company's "boring" corporate filings, reviewing its financial statements, evaluating its intrinsic value and then assessing whether its share price offers a favourable risk/reward opportunity. Thus far our process has proven to be quite effective.

All of this leads me to the recent market turmoil.

Is this the start of a correction?

Markets have taken a bit of a tumble over the past six weeks. That being said, at the time of writing, the S&P500 is off only 5% from its high, while the TSX is down about 10%. As we have been saying for some time, stocks are not cheap, as low interest rates have pushed valuations higher. This is highlighted in the chart below, which depicts current versus historic P/E multiples (which are normalized and inflation-adjusted) – a rough barometer of where valuations currently stand.



(source: gurufocus)

Over the past couple of days we have seen a rally. Is this the end of a short-term correction, or is there more downside from here?

The short answer: we do not know. What is more important is that we have been very conservatively positioned for quite some time and have thankfully avoided areas of the market that appeared overpriced, such as gold, copper and the Canadian energy sector. What we do know is that the world's economy is still having trouble gaining traction, despite numerous attempts by governments and central banks to boost output.

Last week, yet again, the IMF cut its forecast for global growth, causing a steep decline in the prices of a wide range of natural resources. Amidst the recent pullback, the commodity that has garnered the greatest amount of attention among investors is oil.

Over a Barrel

The price of West Texas Intermediate crude oil (WTI) dropped to its lowest level in more than two years, falling below $80.00/barrel at one point. Aside from the gloomier economic forecasts, lower oil prices have also been driven by a number of other factors, the most significant being the huge increase in U.S. crude production from shale. Increased supply, combined with ever more efficient uses of energy and demand growth weaker than expected, has resulted in excess inventories.

All of this, of course, has had a dramatic impact on oil companies. Recent years have seen the oil majors guilty of "chasing barrels," a term industry analysts use to call attention to the practice of pursuing production growth without regard for the associated operating costs and capital required.

Over the past two years, the world's largest non-state explorers invested $300 billion in new projects (source: Bloomberg). The oil companies were already facing difficulties when prices were comfortably above $100/barrel. As they continued to explore and produce oil in harder to reach places, their operating costs began to surge. The fact that oil prices have now plunged, is forcing the entire industry to reassess which projects to pursue, as the cost of producing oil from certain areas has left some projects uneconomical. Unsurprisingly, a number of companies, such as Suncor, Total and Statoil have had to shelve or delay projects in the Alberta oil sands.

These operational problems have not gone unnoticed by investors, and have only been compounded by the lower oil prices. Not surprisingly, the oil sector, especially in Canada, has been among the worst performers in the recent market downturn.

Nevertheless, the news is not all bad, as the longer-term outlook for oil prices remains positive for many industry observers. This is supported by the increasing demand for oil by a growing middle class in the developing world – even if growth forecasts for those countries have been lowered in the short-term. Furthermore, oil companies have since become more selective in the projects that they are pursuing and many have been selling non-core assets in order to generate cash. Both BP and Total have indicated that they will use their excess cash to support share buybacks and dividend increases, while being prudent when it comes to acquisitions – all of which bodes well for shareholders, such us ourselves.

High Yield Bonds

A review of the high yield bond market and our high yield fund is available here: High Yield Quarterly.

Final Thoughts

With the plethora of information at our fingertips – research reports, round-the-clock commentary and analysis, and the 24-hour news cycle – one might think that it is easier for investors to succeed today than it was twenty years ago, before the internet changed our world.

Think again.

The reality is that investment performance is no better today than it was then, because having information does not guarantee good judgement. It is the evaluation and assessment of the relevance of information that is critical. A speculator may be able to make a few dollars by reacting quickly to a news flash. However, an investor creates enduring wealth by using rigorous analysis to identify companies that are trading at a steep discount to intrinsic value, while keeping risk to a minimum. As Albert Einstein put it, **"information is not knowledge."**

As always, we welcome the opportunity to discuss our outlook and investments with you.

Sincerely yours,

Lorne Steinberg
President