

## Dodge Ball

We feel like we dodged a bullet in 2011. Depending on which index you look at, Canadian equity markets were down somewhere between 11% and 35% in 2011. Fortunately, the Capital Ideas Fund managed to eke out a positive return (+5.3%) in the same time frame. We expect better in 2012. This does not mean that we are unaware of the risks that surround us but risks must be weighed with opportunity and we think equities as an asset class are incredibly underpriced relative to other asset classes. We expect Canadian equity markets and the Capital Ideas Fund to each perform better in 2012 than they did in 2011.

### **Recency Effect**

The recency effect is described by psychologists as the tendency to remember or over-emphasize more recent experiences relative to those that occurred a while ago, even when both sets of experiences have similar or equal relevancy. The recency effect comes up in investing all the time because we tend to favour investments that have recently performed well, while ignoring investments that have recently disappointed but have a favourable long-term track record. A recent chat with my good friend Paul Marsiglio provides interesting insights into the recency effect as it relates to investors in Canadian stock market and real estate assets.

Paul Marsiglio is both a friend and an intelligent investor. Marsiglio has lived the fairly typical Canadian dream – by that I mean he is the child of immigrants and was raised in a world where hard work, thrift, honesty and family were considered to be the cornerstones of a great life. Marsiglio started working alongside his father Luigi, a bricklayer in the 1970's and by the time he was 20 he knew how a house was built and this inevitably led to a fascination and career in real estate. Following university, Marsiglio found himself working for a real estate consultancy firm and by his mid-30's (the early 1990's) he had developed a strong understanding of the fundamentals that drive the real estate market in general and the Toronto market in particular.

At the same time that Marsiglio's knowledge of the real estate field was beginning to mature the Canadian real estate market was going through a severe slump. This downturn had started in the late 1980's and by 1993 many investors in Toronto real estate assets had sworn off the asset class believing that it would provide nothing but an ongoing heartache. Marsiglio remembered speaking to many investors at that time who simply wanted out at any price – what we now commonly refer to as the “capitulation trade”.

Going back to the early 1990's, Marsiglio remembers it as a time when unlevered cap rates were hovering as high as 10-11%. A cap rate is roughly equivalent to the yield on a fixed income asset or the earnings yield of a stock (which is the inverse of its P/E ratio). Thus, with a reasonable amount of leverage an investor could take a cap rate of 11% and achieve an annualized return of +20%. Apartment units which had recently been built and had a replacement cost of \$100,000 per unit were selling for \$35,000 per unit and obtaining financing on units was relatively easy. Yet in 1993, the market seemed to be dominated by sellers. Marsiglio on the other hand was not swayed by the recency effect. He bought real estate assets in the early 1990's and within a few years these investments had paid off spectacularly. Those caught in the headlights of the “recency effect” were the people he bought from.

Nineteen years later, Marsiglio remains a keen student of the investment game. Currently he holds very few real estate investments because the inverse of what he saw in 1993 has occurred over the past two decades. Cap rates are currently as low as 2% in some cases (the Toronto Condo market) and seemingly everyone believes that the spectacular returns and preservation of capital that have been earned in real estate over the recent past will be sustained. Marsiglio however is sceptical. At the same time, Marsiglio is extremely excited about another asset class – and that asset class is stocks.

According to Marsiglio, the stock market today looks exactly like the Toronto real estate market did in 1993. Valuations are “crazy good” and yet investor fatigue is both palpable and ubiquitous. People are sceptical of earnings yields of 10-15% while seemingly embracing real estate cap rates of 2-3%. For Marsiglio, 2012 looks like 1993 all over again except now the Toronto real estate sector looks overvalued while the stock market looks absurdly cheap.

There are sophisticated mathematical models to explain market valuation differentials but sometimes just putting the numbers down in a table is more than enough. Let's assume that we live in a world where only three asset classes exist. They are 1) short-term government T-bills, 2) Toronto real estate and 3) Stocks as represented by the earnings yield on the S&P. Figure 1 shows the comparative yields in 1993 and 2012 of these three asset classes and for illustration purposes we have also added the estimated earnings yield for the DKAM Capital Ideas Fund.

<b>Figure 1 - Comparative returns of different asset classes - 1993 to 2012</b>		
Asset	1993	2012
T-Bills	3.0%	0.0%
Toronto real estate cap rates	11.0%	2.0%
Earnings yield - S&P	4.3%	7.5%
Earnings yield - Cap Ideas - est	NA	11.0%
<i>Source: DKAM Estimates</i>		

What Figure 3 shows is that, absent of any risk adjustment, Toronto real estate was the place to be in 1993, whereas today the stock market is a far more attractive place to invest. Of course, each of these asset classes has different risk profiles. The T-bill rate is sometimes referred to as the risk-free rate but it also should be pointed out that T-bills currently offer close to a zero return. The risk profile of stocks vs. real estate is tougher to quantify but I would argue in the long-run that neither real estate nor the stock market are more or less risky than the other. As such, we believe stocks are the place to be as we head into 2012.

### **Super Stocks for 2012**

Our approach to picking stocks that will outperform the market in the long-run is to start with return on equity. Why do we view ROE to be so important? The equity (or E in ROE) is sometimes referred to as the net worth of a business and as such, the return on equity is what we feel is the best measure of how fast a business is actually growing. The other reason why ROE is so important is because it is often a strong measure of the competitive advantage of a business. Any firm that can generate a high ROE (+15%) for more than 2-3 years in a row is probably one that possesses or has developed some kind of competitive advantage. Looking into 2012, the 25 companies that we follow in Canada with the best “projected” ROE are presented in Figure 2.

**Figure 2 - High ROE stocks in Canada - Based on 2012 DKAM estimates**

Rank	Company	Ticker	Industry	Market Cap	ROE
1	Constellation Software	CSU	Technology/Software	1,616.6	48%
2	Neo Material Technologies	NEM	Rare Earth	864.5	43%
3	Bri-chem	BRY	Chemicals	51.7	39%
4	Asia Television	SAT	Media	70.8	39%
5	Potash Corp	POT	Fertilizer	35,849.3	38%
6	Canyon Services Group	FRC	Oil and gas services	665.1	34%
7	Carfinco	CFN	Specialty Lender	170.5	34%
8	Garda World	GW	Security	228.5	32%
9	Macdonald Detwiler	MDA	IT	1,487.0	31%
10	Lorex Technology	LOX	CCTV Camera	13.5	29%
11	Centric Health	CHH	Healthcare	239.8	29%
12	IMAX	IMX	Movies	1,213.6	28%
13	Points International	PTS	Loyalty programs	116.8	28%
14	China Green Star	GRE	Food	21.8	27%
15	Pethealth	PTZ	Insurance	30.2	27%
16	RIFCO	RFC	Car loans	17.6	26%
17	Opmedic	OMG	Fertility Clinics	54.5	26%
18	Home Capital	HCG	Specialty Lender	1,725.6	25%
19	Glentel	GLN	Cell Phone sales	390.8	25%
20	Wi-Lan	WIN	Tech and royalties	572.2	24%
21	CGI Group	GIB.A	IT services	4,965.6	24%
22	Aston Hill Financial	AHF	Asset Manager	102.2	24%
23	Total Energy Services	TOT	Oil and gas services	539.3	23%
24	Paladin Labs	PLB	Pharma	815.7	23%
25	Open Text	OTC	Software	2,976.3	23%

Of course, we do not simply buy stocks from a menu. If we discover a company that interests us we read their annual reports, talk to analysts and typically get in our car or on a plane and go visit with management. If we like what we see, we begin to build a position. For us, what is really important is identifying companies that earn high ROE's that we feel can be sustained. Thus, several of our favourite companies are listed on Figure 2 while at the same time there are several other companies in Figure 2 that are delivering high ROE's that we doubt are sustainable.

The other thing that investors like us look for are low valuations. In Figure 3 we present the same stocks that appear in Figure 2 but this time we rank the group in terms of price to earnings ratios. The way we think about valuation is as follows. First, we try to identify the best 25 companies in Canada to invest in and then second, we try to focus on the 4-5 that appear to be on sale that week. Figure 3 shows that some of the best companies in Canada are remarkably cheap in price to earnings terms but a couple are also quite expensive. Thus, our focus is on those companies that have BOTH sustainably high ROE's and low P/E ratios.

Figure 3 - High ROE stocks in Canada - Based on 2012 DKAM estimates- Ranked by P/E					
Rank	Company	Ticker	Industry	Market Cap	PE
1	Lorex Technology	LOX	CCTV Camera	13.5	3.0
2	China Green Star	GRE	Food	21.8	3.0
3	Bri-chem	BRY	Chemicals	51.7	3.3
4	Neo Material Technologies	NEM	Rare Earth	864.5	4.2
5	Pethealth	PTZ	Insurance	30.2	5.2
6	RIFCO	RFC	Car loans	17.6	5.3
7	Canyon Services Group	FRC	Oil and gas services	665.1	5.4
8	Wi-Lan	WIN	Tech and royalties	572.2	6.6
9	Centric Health	CHH	Healthcare	239.8	6.9
10	Home Capital	HCG	Specialty Lender	1,725.6	7.2
11	Total Energy Services	TOT	Oil and gas services	539.3	7.6
12	CGI Group	GIB.A	IT services	4,965.6	7.8
13	Carfinco	CFN.UN	Specialty Lender	170.5	8.0
14	Opmedic	OMG	Fertility Clinics	54.5	8.7
15	Garda World	GW	Security	228.5	8.9
16	Constellation Software	CSU	Technology/Software	1,616.6	9.1
17	Paladin Labs	PLB	Pharma	815.7	10.1
18	Open Text	OTC	Software	2,976.3	10.5
19	Glentel	GLN	Cell Phone sales	390.8	10.6
20	Potash Corp	POT	Fertilizer	35,849.3	10.9
21	Asia Television	SAT	Media	70.8	12.7
22	Macdonald Detwiler	MDA	IT	1,487.0	13.3
23	IMAX	IMX	Movies	1,213.6	16.8
24	Aston Hill Financial	AHF	Asset Manager	102.2	20.5
25	Points International	PTS	Loyalty programs	116.8	21.7

Figure 4 is our culled list of companies that we are focusing on. From the previous two lists we have tried to distill our list by eliminating companies that are too small, do not have long term track records, or have inconsistent track records in an historical context. The stocks in Figure 4 are then ranked by the ratio of ROE to P/E. Stocks that appear at the top of the list possess the most “units of ROE” per “unit of P/E”. From these, we have selected 5 which we view as the best Super Stock candidates for 2012.

Figure 4 - High ROE Stocks in Canada - Based on 2012 DKAM Estimates - Ranked by ROE*/PE*					
Rank	Company	Ticker	Industry	Market Cap	ROE/PE
1	Neo Material Technologies	NEM	Rare Earth	864.5	10.2
2	Canyon Services Group	FRC	Oil and gas services	665.1	6.3
3	Constellation Software Inc.	CSU	Technology/Software	1,616.6	5.3
4	Centric Health	CHH	Healthcare	239.8	4.2
5	Wi-Lan	WIN	Tech and royalties	572.2	3.7
6	Garda World	GW	Security	228.5	3.6
7	Potash Corp	POT	Fertilizer	35,849.3	3.5
8	Home Capital Group Inc.	HCG	Specialty Lender	1,725.6	3.4
9	CGI Group	GIB.A	IT services	4,965.6	3.1
10	Total Energy Services inc	TOT	Oil and gas services	539.3	3.0
11	Glentel	GLN	Cell Phone sales	390.8	2.4
12	Macdonald Detwiler	MDA	IT	1,487.0	2.3
13	Paladin Labs	PLB	Pharma	815.7	2.3
14	Open Text	OTC	Software	2,976.3	2.2
15	IMAX	IMX	Movies	1,213.6	1.6

Note - ROE\* is adjusted for cash earnings, dividend payouts and based on estimated average equity

## Super Stocks

Our definition of a great stock to own (a Super Stock) is one that can consistently grow earnings from year to year at a rate that is well above the market growth rate without resorting to accounting gimmickry or excessive leverage. The truly great companies can also be held for many years without triggering any capital gains. These also tend to be very good stocks for the general investor because they don't require continuous monitoring. Investors in these kinds of companies can sleep at night, as stocks such as these represent the true embodiment of a buy and hold strategy. Our super stock candidates for 2012 are Constellation Software, Home Capital Group, CGI Group, Glentel and Paladin Labs.

**Constellation Software** – has been one of our core holdings for years and is currently the largest position in the Capital Ideas Fund. Constellation is a free cash flow machine and run by a superb management team. Last year, Constellation's share price rose by more than 50% and we think 2012 will be another exceptional year. But don't take our word for it. On the first day of January management halted the stock and promptly doubled the dividend, and the stock now yields 4.7%. That should be about as clear a signal as you need to sense what kind of year management is anticipating.

Figure 5 - Constellation Software								
FYE Dec	2005A	2006A	2007A	2008A	2009A	2010A	2011E	2012E
Rev (\$MM)	165.4	210.8	243.0	330.5	437.9	630.9	785.3	928.9
Cash Earnings (\$MM)	12.7	15.9	33.5	57.6	70.8	111.8	240.6	177.6
Cash EPS (\$)	0.64	0.76	1.59	2.73	3.35	5.28	11.34	8.37
Net margin (%)	7.7%	7.5%	13.8%	17.4%	16.2%	17.7%	30.6%	19.1%
ROE*	NA	NA	40%	63%	70%	87%	116%	60%

Source: Donville Kent

**Home Capital Group** – remains one of the best managed companies in Canada and the third largest position in the DKAM Capital Ideas Fund. This Company has shown, for close to two decades, that it can handle both the risks as well as the opportunities inherent in the Canadian Mortgage Industry. While we have some concerns about the real estate market in general in Canada, Home’s tendency to lend at a low ratio (on average less than 70% of the value of the house) will protect it from even a steep drop in prices. Home Capital’s ROE has not fallen below 20% since the mid 1990’s and we don’t see anything on the horizon that will change that.

Figure 6 - Home Capital Group								
FYE Dec	2005A	2006A	2007A	2008A	2009A	2010A	2011E	2012E
Rev (\$MM)	198.8	241.1	320.8	374.0	365.1	382.2	440.0	510.0
Cash Earnings (\$MM)	60.6	67.8	90.2	108.7	144.5	180.9	208.0	239.2
Cash EPS (\$)	1.80	1.99	2.62	3.15	4.19	5.21	5.99	6.89
Net margin (%)	30.5%	28.1%	28.1%	29.1%	39.6%	47.3%	47.3%	46.9%
ROE*	32%	27%	29%	28%	28%	30%	29%	26%

Source: Donville Kent

**CGI Group** - CGI at first glance does not appear to be growing as quickly as some of the others on the list. However, the Company has aggressively bought back its stock over the years and thus while revenues are growing at a decent pace, EPS is growing much faster. There are two other reasons we like CGI. The first is its diverse revenue base which mitigates risk for investors who want to sleep at night. The second is its valuation. Large cap liquid stocks usually don’t trade this inexpensively. CGI Group is the fourth largest position in the DKAM Capital Ideas Fund.

Figure 7 - CGI Group								
FYE Sep	2005A	2006A	2007A	2008A	2009A	2010A	2011A	2012E
Rev (\$MM)	3685.0	3477.6	3633.0	3705.9	3825.1	3732.1	4323.2	4323.2
Cash Earnings (\$MM)	344.7	266.2	359.1	394.9	418.0	455.6	544.6	638.9
Cash EPS (\$)	0.78	0.73	1.09	1.24	1.36	1.60	2.05	2.41
Net margin (%)	9.4%	7.7%	9.9%	10.7%	10.9%	12.2%	12.6%	14.8%
ROE*	NA	NA	NA	21%	20%	21%	24%	24%

Source: Donville Kent

**Glentel** – The Burnaby based phone retailer has emerged as one of the darlings of the Canadian retail market as it operates the only major independent cell phone store chain in Canada. The Company’s recent expansion into the US is also continuing to perform well and with another round of smart phones and tablets about to be launched in 2012, it should be another great year for Glentel. Glentel is the 9<sup>th</sup> largest position in the DKAM Capital Ideas Fund.

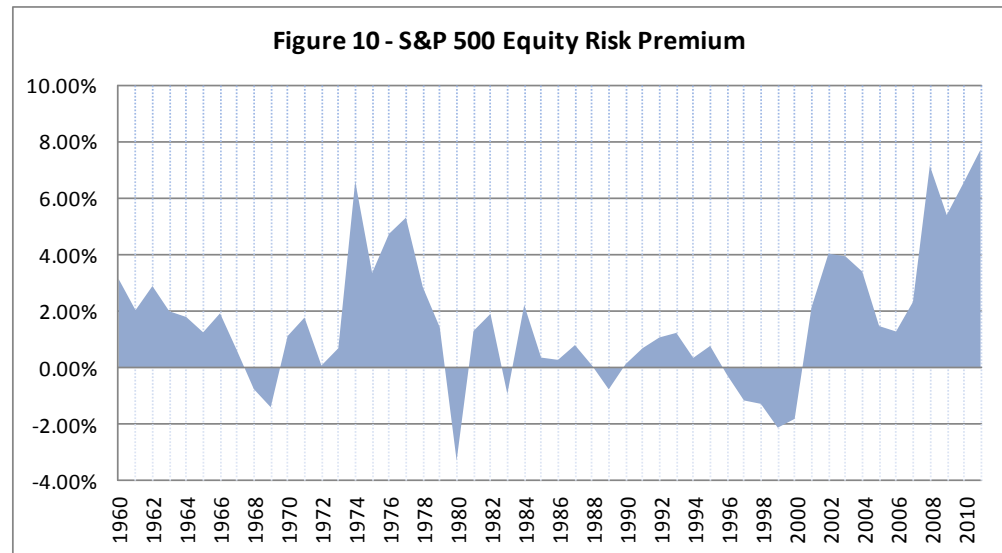
Figure 8 - Glentel									
FYE Dec	2005A	2006A	2007A	2008A	2009A	2010A	2011E	2012E	
Rev (\$MM)	143.1	181.2	221.6	289.3	308.1	412.3	620.0	713.0	
Cash Earnings (\$MM)	6.1	6.3	10.6	14.1	16.3	26.3	32.2	37.0	
Cash EPS (\$)	0.30	0.31	0.50	0.66	0.73	1.20	1.46	1.67	
Net margin (%)	4.3%	3.5%	4.8%	4.9%	5.3%	6.4%	5.2%	5.2%	
ROE*	16%	13%	20%	24%	24%	29%	33%	30%	
<i>Source: Donville Kent</i>									

**Paladin Labs** – The Montreal based drug manufacturer continues to grow its top and bottom line by at least 15% per annum and this stock has virtually no economic cycle sensitivity. The Company is also sitting on a huge pile of cash (\$250MM) which means that large and accretive acquisitions could occur at any time. Paladin CEO Jonathan Goodman, who has been recovering from a cycling accident, is now well on his way to recovery which also bodes well for Paladin in 2012. Paladin Labs is the second largest position in the DKAM Capital Ideas Fund.

Figure 9 - Paladin Labs									
FYE Dec	2005A	2006A	2007A	2008A	2009A	2010A	2011E	2012E	
Rev (\$MM)	33.7	48.4	62.9	82.7	109.7	128.0	160.0	190.0	
Cash Earnings (\$MM)	7.8	13.1	21.5	26.4	36.8	52.6	67.0	80.4	
Cash EPS (\$)	0.53	0.88	1.44	1.78	2.08	2.81	3.58	4.30	
Net margin (%)	23.1%	27.1%	34.2%	31.9%	33.5%	41.1%	41.9%	42.3%	
ROE*	12%	19%	28%	30%	25%	25%	25%	23%	
<i>Source: Donville Kent</i>									

## Outlook for 2012

As I stated at the outset of this newsletter I expect that 2012 will be a good year for the market for several reasons. The first reason is one that I have been talking about for some time and that is the equity risk premium. We go through long cycles of optimism and pessimism in the investing world and this creates great opportunities for investors who can think counter intuitively. The equity risk premium can be seen as a very good gauge of investor optimism and pessimism and in hindsight we know that market bottoms tend to coincide with extreme market pessimism and vice versa. With the equity risk premium currently sitting at record highs, my sense is that we will probably look back in a decade's time and view today's equity markets as a terrific time to own stocks.



I suppose our bullishness for 2012 is also driven by our view of stock market cycles. In a general sense, we tend to see the up cycle of the stock market as being roughly 60 months in duration and often use the length of a baseball game to illustrate our idea. The current market up-cycle began in March 2009 so we expect the market to be in an upswing until roughly the first quarter of 2014. The first three innings of the up-cycle (first 20 months) tend to be very positive and are now behind us. Innings 4-6 tend to be when the market experiences a mid-cycle correction before resuming its climb into innings 7-9. Then it's typically a 12-18 month down cycle and we start all over again.

So where are we in this particular cycle? Our best guess is that we are roughly at the start of the 5<sup>th</sup> inning. As important, with all of the Canadian indexes having had a poor year in 2011, our sense is that the mid-cycle correction has occurred. This leads us to believe that 2012 will be a positive year for the stock market and if we do get a big move there is a high probability that it will be an explosive movement up.

### **Final Comments**

The world at times seems full of bad news. However, there is a silver lining to a lot of what seems to be troubling this world. We expect the cloud of pessimism that seems to have been particularly persistent over the past few years to lift. The world will soon begin to realize that many of our so-called problems are leading to constructive changes that will in the end make the world a better place. I'm optimistic about the future, both yours and mine. Call if you want to chat – *JP Donville* – 416 - 364 - 8886