

## In praise of common stock ownership

2010 has been another good year for investors in common equities with indices in both Canada and the US up nicely. For 2011, we expect another strong year for equity performance, given the state of corporate earnings, the slope of the yield curve, and long-term valuations, particularly when seen in the context of the risk free rate. In this edition of the ROE Reporter our bullishness for 2011 is assumed. Our intent in this report is to lead you through our investment approach so that you can see how we think and for those of you who are interested, provide you with five stocks that we believe will serve your portfolios well in 2011. For those investors who would prefer that we do the heavy lifting, please note that we already hold each of the five recommended stocks in either the Donville Kent Capital Ideas or Financial Services Fund, or both.

### Is owning a common stock such a bad thing?

Regardless of where you are at in your investment life cycle, your investment portfolio will almost certainly require that you own shares in public companies. If you are not prepared to do this then you essentially have three other investment options – these are 1) money markets and related short term deposits, 2) government bonds and 3) corporate bonds. Of course, the problem with options 1 and 2 are that they now pay extremely poorly. Option 3 in our view does have merit but from a risk perspective one should not lose track of the fact that, like common shares, with corporate debt you are still buying an investment with cash flows linked to the fortunes of a public company. So get used to it – the vast majority of us are going to have to build our nest eggs through investing in public company equity or debt.

Is this a bad thing? Most of the great fortunes of our time have come from investments in superb companies that enjoyed a sustained period of compound earnings growth. The Rockefellers got rich through Standard Oil, Bill Gates got rich through Microsoft and Mike Lazaridis and Jim Balsillie got rich through Research in Motion. However, one could quite rightly point out that these men were entrepreneurs and that their wealth came primarily from businesses that they created from scratch, and hence these opportunities were inaccessible to other investors. This is quite true, but the list of the super-wealthy also includes people like Warren Buffett, James Pattison and Murray

Edwards. While these men have certainly been successful entrepreneurs they have made their greatest fortunes from the timely purchases of businesses that they did not create themselves. The message here is that if one is not able to create a great business from scratch, one can still become wealthy by being an astute investor in existing superb businesses.

So how does one become the next Buffett, Pattison or Edwards? It starts with a basic investment framework which will be explained over the next few pages. However, before we flesh out our investment framework, let's expand slightly upon what we hope to avoid – investments in companies that decline significantly in value. Stock investments go down in value primarily for two reasons – either because the company delivers lower levels of earnings than we had previously expected or the price multiple of earnings (P/E ratio) that the market is prepared to pay for those earnings contracts.

To illustrate this point, consider a stock we might buy for \$10.00 per share at the start of 2011. Over the course of the next 12 months, we expect this Company will earn \$1.20 in earnings, up from \$1.00 in earnings in 2010. We believe the stock, which currently trades on 10x earnings will continue to trade at 10x earnings, and thus we expect the stock's share price will rise from \$10.00 a share to \$12.00 a share over the course of 2011. This would provide us with a very decent return of 20% on our investment.

So what can go wrong with this scenario? The answer is many things, but these can be distilled into two broad risks. First, the company can earn less than the \$1.20 that was predicted at the start of the year. So for now, let's assume that the company earns \$0.90 a share instead of the predicted \$1.20. Assuming the stock still trades at 10.0x earnings then the investment now falls from \$10 per share to \$9 per share, a 10% loss. However, the other factor that can change is the multiple that the market will pay for those earnings. Let's say that over the course of 2011 the market became increasingly worried about some macro-economic risk and as such, the multiple that the market would now pay for the earnings of our company fell from 10x to 8x. This would mean our stock, which saw its earnings drop from \$1.00 to \$0.90 would fall even more than the drop in earnings because the earning multiple (P/E Ratio) contracted from 10x to 8x. Thus, our stock would be valued at 8x the \$0.90 that it will now earn in 2011 which equates to a share price of \$7.20. The result is a 28% loss.

So how do we mitigate the twin risks described above? First of all, the answer is that one never completely avoids these risks – what one does is create a “margin of safety” that allows one to “win big” when one wins, and “lose small” when one loses. The term “margin of safety” in an investment context was coined by Benjamin Graham and David Dodd and in essence the margin of safety refers to the difference between the intrinsic value of a stock and its market price. Graham and Dodd were first and foremost “value” investors and thus capital preservation was an important goal in their investment process. Thus, the margin of safety concept was about buying a stock that was so undervalued that if something were to go wrong one wouldn't lose much on the stock. This of course sounds great in theory but the challenge for investors

was to take Graham and Dodd's general comments on margin of safety and build a practical investments strategy around it.

To this end, we can thank Graham and Dodd's greatest student and employee, Warren Buffett, for expanding upon the "margin of safety" concept with the vast amount of this wisdom presented in the form of the annual reports of Berkshire Hathaway. From these pages of wisdom we can take some of Graham and Dodd's basic tenets and develop them into a practical investment philosophy that can guide investors on a day to day basis.

In Buffett's world, margin of safety comes down to buying "above average" companies for "below average" prices. So what does an above average company look like? According to Buffett, "the best business to own is one that over an extended period can employ large amounts of incremental capital at very high rates of return. The worst business to own is one that must or will do the opposite – that is, consistently employ ever-greater amounts of capital at very low rates of return".<sup>1</sup> Buffett adds, "Our goal is to find an outstanding business at a sensible price, not a mediocre business at a bargain price"<sup>2</sup>

Throughout the Berkshire Hathaway annual reports, Buffett reiterates his definition of a high quality company as one with the ability to earn a high return on equity on a sustained basis. He also adds several other qualities of a great business including an honest management that is capable of allocating capital wisely and a business that operates within a favorable economic environment that allows the company to enjoy predictable and sustained levels of earnings growth.

So why is a high ROE so important? There are really two main reasons. First, a company's equity is sometimes referred to as its net worth and ROE is therefore an excellent measure of the true underlying growth rate of the value of the enterprise. Thus, a company with a 22% ROE and no dividend should be worth roughly 22% more in a year than it is today. The same goes with a company with a 3% ROE – so which would you rather own? However, there is a second reason why ROE is extremely important. High ROE's are often symptomatic of companies that possess significant competitive advantages which allow them to earn above average ROE's on a sustained basis. Buffett refers to this competitive advantage as the "moat" that is built around an exceptional business. Recall that we earlier identified two key risks for investors in common stocks and the first one was the possibility that the Company earns less than we had expected. Buffett believes as we do that companies with significant "moats" built around them are less likely to disappoint on the earnings front in future years.

Bringing our discussion around to a more practical bent, let's now focus on high ROE companies in Canada. We estimate that the long run ROE for the average stock in the Canadian market is roughly 11%. Building in a margin of safety, we therefore want to invest in companies that are "better" than the

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<sup>1</sup> Warren E. Buffett and Lawrence A. Cunningham, *The Essays of Warren Buffett: Lessons For Corporate America – Second Edition*, page 102

<sup>2</sup> Buffett and Cunningham, page 98

market and for this we will use an ROE of 15% as our cut-off for an exceptional business. In our database of roughly 300 companies, the top 25 non-resource ROE companies based on our look into 2011 are presented in figure 1 below. Note that these ROE numbers have been adjusted to reflect “owner’s earnings” and differences in dividend payout ratios and give no insights into the sustainability of the ROE. Nonetheless, for investors who aspire to become the next Buffett, Pattison or Edwards, this is where we suggest you start.

**Figure 1 - High ROE stocks in Canada - Based on 2011 DKAM Estimates**

Rank	Company	Ticker	Industry	Market Cap	ROE
1	Constellation Software Inc.	CSU	Technology/Software	1,059.0	71%
2	Garda World	GW	Security	289.5	53%
3	Carfinco Income Fund	CFN.UN	Specialty Lender	169.9	36%
4	Sprott Inc	SII	Asset Manager	1,343.0	31%
5	BMTC Group	GBT.A	Consumer products	1,074.2	30%
6	Gluskin Sheff + Associates Inc.	GS	Asset Manager	600.1	29%
7	Critical Control Solutions	CCZ	Oil and gas services	30.0	28%
8	Pareto	PTO	Advertising	83.1	27%
9	Points International	PTS	Loyalty programs	107.9	27%
10	Canyon Services Group	FRC	Oil and gas services	659.0	27%
11	Healthscreen	MDU	Healthcare software	11.2	27%
12	Sylogist	SYZ	E-Finance	36.5	27%
13	Glentel	GLN	Cell Phone sales	275.0	25%
14	Evertz Technologies	ET	Tech Mfg	1,263.7	25%
15	Centric Health	CHH	Healthcare	55.0	25%
16	Home Capital Group Inc.	HCG	Specialty Lender	1,781.5	24%
17	MTY Foods	MTY	Food franchising	281.1	24%
18	Open Text	OTC	Software	2,716.7	23%
19	Phoenix Technology Income Fund	PHX.UN	Oil and gas services	330.2	23%
20	Opmedic	OMG	Fertility Clinics	43.7	23%
21	Bridgewater Systems	BWC	Software	196.8	23%
22	CGI Group	GIB.A	IT services	4,754.5	22%
23	Score Media	SCR	Sports Media	74.7	22%
24	Paladin Labs	PLB	Pharma	593.2	22%
25	Cathedral Energy Services	CET	Oil and gas services	328.0	21%

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

Figure 1 presents a list of Canadian companies that are currently earning exceptionally good returns on equity. However, before we proceed to a closer look at each company, let us recall that “margin of safety” has two components, namely quality (which we seek to maximize) and valuation (which we seek to minimize). Figure 1 only speaks to the first half of the issue. In our earlier example we showed what happened to a company that missed its earnings and our contention that focusing on high ROE stocks helps minimize or lessen the risk or likelihood of earnings disappointments. However, the second risk in our example was the impact of P/E multiple compression on a company’s share price. Here, the risk minimization strategy is to buy stocks that are as cheap as possible with the underlying rationale being as follows – if multiples contract, the stock that is trading on the loftiest multiple of P/E has the farthest to fall, all things being equal. So let’s once again look at our list of high ROE companies with an emphasis on the ones that are trading on low P/E’s, which we have done in figure 2 below.

Rank	Company	Ticker	Industry	Market Cap	P/E*
1	Critical Control Solutions	CCZ	Oil and gas services	30.0	4.1
2	Home Capital Group Inc.	HCG	Specialty Lender	1,781.5	8.4
3	Sylogist	SYZ	E-Finance	36.5	8.5
4	Pareto	PTO	Advertising	83.1	8.8
5	CGI Group	GIB.A	IT services	4,754.5	8.8
6	Garda World	GW	Secuirty	289.5	9.1
7	Constellation Software Inc.	CSU	Technology/Software	1,059.0	9.2
8	Healthscreen	MDU	Healthcare software	11.2	9.4
9	Centric Health	CHH	Healthcare	55.0	9.4
10	Bridgewater Systems	BWC	Software	196.8	9.8
11	Canyon Services Group	FRC	Oil and gas services	659.0	10.0
12	Glentel	GLN	Cell Phone sales	275.0	10.0
13	Phoenix Technology Income Fund	PHX.UN	Oil and gas services	330.2	10.3
14	Opmedic	OMG	Fertility Clinics	43.7	10.4
15	Cathedral Energy Services	CET	Oil and gas services	328.0	10.7
16	Open Text	OTC	Software	2,716.7	11.4
17	Carfinco Income Fund	CFN.UN	Specialty Lender	169.9	11.5
18	BMTC Group	GBT.A	Consumer products	1,074.2	11.5
19	Paladin Labs	PLB	Pharma	593.2	11.8
20	MTY Foods	MTY	Food franchising	281.1	12.3
21	Evertz Technologies	ET	Tech Mfg	1,263.7	13.6
22	Gluskin Sheff + Associates Inc.	GS	Asset Manager	600.1	14.1
23	Score Media	SCR	Sports Media	74.7	14.3
24	Sprott Inc	SII	Asset Manager	1,343.0	16.2
25	Points International	PTS	Loyalty programs	107.9	21.8

Note - P/E\* is adjusted for cash earnings

So how low does a P/E ratio need to be in order to be attractive? We can look at valuation from a number of different perspectives but a simple method is to merge the data from Figures 1 and 2 into a third figure which creates a ratio that ranks the companies in our list by the amount of ROE one can buy relative to the amount of P/E one has to spend. Put another way, we can rank our list so that it shows us which companies provide us with the most units of growth (ROE) per unit of valuation (P/E). This is what has been done in figure 3. It should also be noted that for discussion purposes we have now removed from our list companies with market capitalizations below \$250MM which will allow us to focus our comments on stocks that have sufficient track record and size to warrant a more detailed discussion.

Rank	Company	Ticker	Industry	Market Cap	ROE/P/E*
1	Constellation Software Inc.	CSU	Technology/Software	1,059.0	7.70
2	Garda World	GW	Secuirty	289.5	5.80
3	Home Capital Group Inc.	HCG	Specialty Lender	1,781.5	2.90
4	Canyon Services Group	FRC	Oil and gas services	659.0	2.70
5	BMTC Group	GBT.A	Consumer products	1,074.2	2.60
6	Glentel	GLN	Cell Phone sales	275.0	2.50
7	CGI Group	GIB.A	IT services	4,754.5	2.50
8	Phoenix Technology Income Fund	PHX.UN	Oil and gas services	330.2	2.20
9	Gluskin Sheff + Associates Inc.	GS	Asset Manager	600.1	2.10
10	Open Text	OTC	Software	2,716.7	2.00
11	Cathedral Energy Services	CET	Oil and gas services	328.0	1.90
12	Sprott Inc	SII	Asset Manager	1,343.0	1.90
13	MTY Foods	MTY	Food franchising	281.1	1.90
14	Evertz Technologies	ET	Tech Mfg	1,263.7	1.80
15	Paladin Labs	PLB	Pharma	593.2	1.80

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

Up until this point in our discussion, we have completed two steps in our investment process. First, we have defined our investment framework which is to maximize ROE and minimize P/E. The second thing we did was to mine a database for candidate investments in Canada which we have done through the creation of figures 1, 2 and 3. The last thing we will do is to select some investments from our short list of investment candidates. However, before we do that let's think for a moment about how many investments we wish to make.

Most investors are well aware of the merits of diversification but at the same time one must recognize that exceptional companies are rare, and here once again we can rely on Buffett for direction. "Your goal as an investor should simply be to purchase, at a rational price, a part interest in an easily-understandable business whose earnings are virtually certain to be materially higher five, ten and twenty years from now. Over time, you will find only a few companies that meet those standards – so when you see one that qualifies, you should buy a meaningful amount of stock"<sup>3</sup>. What Buffett is clearly addressing is the issue of concentration, although he does not specifically name how many individual stocks an investor should own. Our database contains close to 300 stocks that we track closely, which we have pared down to a list of 25 in figures 1 and 2, and to 15 in figure 3.

Up until now, our process has been largely an intellectual exercise as we pare down the list of possible investments to a manageable level. From here we now typically will meet with the Company's management, build a detailed financial model, and speak with industry experts. If everything we find is consistent with our initial view of the Company then we will proceed to the next level which means that we become a shareholder of the said business. From the list of fifteen companies in figure 3, here are our top five investment ideas for 2011.

**Constellation Software** – The Holy Grail of equity investing is a company that can earn a consistently high return on incremental capital. In this context it's hard to beat Constellation Software (CSU). Over the past five years the Company has had a stellar ROE which is supported by high levels of revenue growth, earnings growth and profit margins. Constellation is based in Toronto, has more than 2,000 employees and operates roughly 40 best of breed software companies throughout North America and Europe. In fact, Constellation Software owns so many different software companies in so many different industries and locations that it no longer offers much industry or firm specific risk. I think senior management should increasingly be viewed as asset allocators above all else and in this context, I cannot name a company of this size in Canada that is better at allocating capital. I would also add that I regard CEO Mark Leonard as the most under-rated CEO in Corporate Canada. Constellation offers investors 7.7 units of ROE per unit of P/E and I can't find a better stock to own in Canada entering 2011 – it is therefore my Top Pick – and has close to a 10% weighting in our Capital Ideas Fund.

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<sup>3</sup> Buffett and Cunningham, page 108

Figure 4 - Constellation Software							
FYE Dec	2005A	2006A	2007A	2008A	2009A	2010E	2011E
Rev (\$MM)	165.4	210.8	243.0	330.5	437.9	622.2	730.0
Cash Earnings (\$MM)	12.7	15.9	33.5	57.6	70.8	98.3	110.4
Cash EPS (\$)	0.64	0.76	1.59	2.73	3.35	4.64	5.21
Net margin (%)	7.7%	7.5%	13.8%	17.4%	16.2%	15.8%	15.1%
ROE*	NA	NA	40%	63%	70%	80%	71%

Source: Donville Kent

**Home Capital** – The Home Capital Group (HCG) is a holding Company that operates through its principle subsidiary, Home Trust Company. Home Trust is a federally regulated trust company offering deposits, mortgage lending, retail credit and credit card issuing services. Since 1998, Home Capital has earned an ROE in excess of 20% without exception and this has allowed it to be the best performing financial services company stock in Canada over the past 15 years. Home Capital boasts a strong management team and business franchise that has performed extremely well in the face of two recent economic downturns. As can be seen in figure 5, Home Capital does not show any sign of slowing down and given its reasonable P/E ratio (at 8.4x 2011 earnings, it is the second cheapest in the group), we expect the company to continue to deliver strong returns for investors. Home Capital is the largest position in our financial services fund and it has a 10.8% weighting in the Capital Ideas Fund.

Figure 5 - Home Capital Group							
FYE Dec	2005A	2006A	2007A	2008A	2009A	2010E	2011E
Rev (\$MM)	198.8	241.1	320.8	374.0	365.1	382.6	451.1
Cash Earnings (\$MM)	60.6	67.8	90.2	108.7	144.5	176.7	212.1
Cash EPS (\$)	1.80	1.99	2.62	3.15	4.17	5.08	6.09
Net margin (%)	30.5%	28.1%	28.1%	29.1%	39.6%	46.2%	47.0%
ROE*	32%	27%	29%	28%	28%	27%	26%

Source: Donville Kent

**Glentel** – Burnaby based Glentel (GLN) is a leading provider of telecommunications products and services in both Canada and the US. Glentel operates 280 stores in Canada under the WIRELESSWAVE, TBooth Wireless and Wireless Etc brands and operates 138 stores in the US under the Diamond Wireless brand. In addition to its retail network, Glentel also operates a business division that provides systems integration and operates 242 towers throughout Canada. Glentel was a good business five years ago but it has quietly become a superb business as it has reallocated capital to its stronger retail divisions. We think the recent acquisition of Diamond Wireless is not as yet factored into Glentel's price and with the ongoing evolution of smart phones, we see another big year for the Company in 2011. We have a 5% weighting in Glentel in the Capital Ideas Fund and expect that weight to grow over the course of 2011.

Figure 6 - Glentel							
FYE Dec	2005A	2006A	2007A	2008A	2009A	2010E	2011E
Rev (\$MM)	143.1	181.2	221.6	289.3	308.1	347.0	485.0
Cash Earnings (\$MM)	6.1	6.3	10.6	14.1	16.3	18.6	28.0
Cash EPS (\$)	0.60	0.62	0.99	1.31	1.46	1.67	2.52
Net margin (%)	4.3%	3.5%	4.8%	4.9%	5.3%	5.4%	5.8%
ROE*	16%	13%	20%	24%	24%	24%	29%

Source: Donville Kent

**MTY Food Group** – Although many investors have never heard of MTY Food Group (MTY), you probably know the company’s restaurant brands. These include Thai Express, Yogen Fruz, Cultures, Sushi Shop, Tiki-Ming, TacoTime, Country Style and TCBY, to name just a few. Montreal based MTY Food Group operates 1,614 quick service restaurants throughout Canada and the company continues to deliver consistently strong results in all economic environments. While MTY does not rank as high in figure 3 as some other companies, there are two important factors that allow MTY to make it on to our top pick list. First, the company has more than \$32MM in cash and no debt on its balance sheet. Thus, if a company like MTY were to take its cash and either buy back its stock or buy more restaurants, its ROE and therefore ranking would be much higher. We expect management to deal with its cash position fairly quickly and hence we regard MTY even more highly than its ranking in figure 3 suggests. The second reason we like MTY relative to some of the other companies in figure 3 is its lack of cyclicity. Great consumer brands are highly sought after in part because of their lock on a certain portion of the consumer’s wallet and in this context we think MTY is one of the most dependable growth companies in Canada. In Buffett speak “the moat around MTY is Huge”!

Figure 7 - MTY Food Group							
FYE Dec	2005A	2006A	2007A	2008A	2009A	2010E	2011E
Rev (\$MM)	18.6	22.0	30.5	34.2	51.5	64.1	78.2
Cash Earnings (\$MM)	4.2	6.6	10.6	11.6	15.1	18.1	21.5
Cash EPS (\$)	0.27	0.38	0.56	0.61	0.79	0.95	1.12
Net margin (%)	22.6%	30.0%	34.8%	33.9%	29.3%	28.2%	27.5%
ROE*	29%	27%	31%	26%	27%	26%	26%

Source: Donville Kent

**Paladin Labs** – Montreal based Paladin Labs (PLB) is a specialty pharmaceutical company with a superb track record for highly profitable growth. Paladin’s strategy is to leverage its strong sales and marketing capabilities with the acquisition and in-licensing of complimentary pharmaceutical products. Paladin’s growth strategy focuses around two thrusts. First, the company will continue to grow by launching innovative products that are sourced from small to medium sized pharmaceutical and bio-tech companies that have limited sales and marketing capabilities. The second thrust is international expansion, which will see Paladin replicate its existing model in other geographies including Africa. Like MTY Food Group, Paladin does not appear as cheap as some of the other companies on our short list.

However, it should be noted that Paladin had \$115M in cash on its balance sheet at the end of Q3/10 and if we adjust either its ROE or valuation for this cash pile, it quickly becomes one of the cheaper growth stocks in Canada. Paladin is the largest holding in the Capital Ideas Fund with and 11.4% weighting.

**Figure 8 - Paladin Labs**

FYE Dec	2005A	2006A	2007A	2008A	2009A	2010E	2011E
Rev (\$MM)	33.7	48.4	62.9	82.7	109.7	129.1	153.6
Cash Earnings (\$MM)	7.8	13.1	21.5	26.4	36.8	43.6	46.3
Cash EPS (\$)	0.53	0.88	1.44	1.78	2.08	2.33	2.47
Net margin (%)	23.1%	27.1%	34.2%	31.9%	33.5%	33.8%	30.1%
ROE*	12%	19%	28%	30%	25%	21%	20%

*Source: Donville Kent*

**Concluding remarks** – In 2010, the Donville Kent Capital Ideas Fund was up 22.8% (versus the index which rose 14.4%) while the Donville Kent Financial Services Venture Fund was up 15.65% (versus the financial services index which rose 4.4%). We expect 2011 will be another good year for equity investors, and that owning a concentrated portfolio of high quality growth stocks that enjoy high ROE’s and are managed by honest and competent managers is the best way to proceed. Call me if you wish to chat further about anything discussed in this report – JP Donville – 416 – 364 – 8886.