

Batter up!

Investors in Canadian equities have enjoyed a rather good start to the year. Market indices were up roughly 5% at the end of March, which if sustained would result in one of the best years of market performance in the past decade. This follows on the heels of strong market returns in 2009 and 2010 and of course raises the question of whether or not we have had too much of a good thing and should therefore be prepared to take some money off the table? My response to both questions is no! I believe the current bull market is only about one third over with lots of upside left.

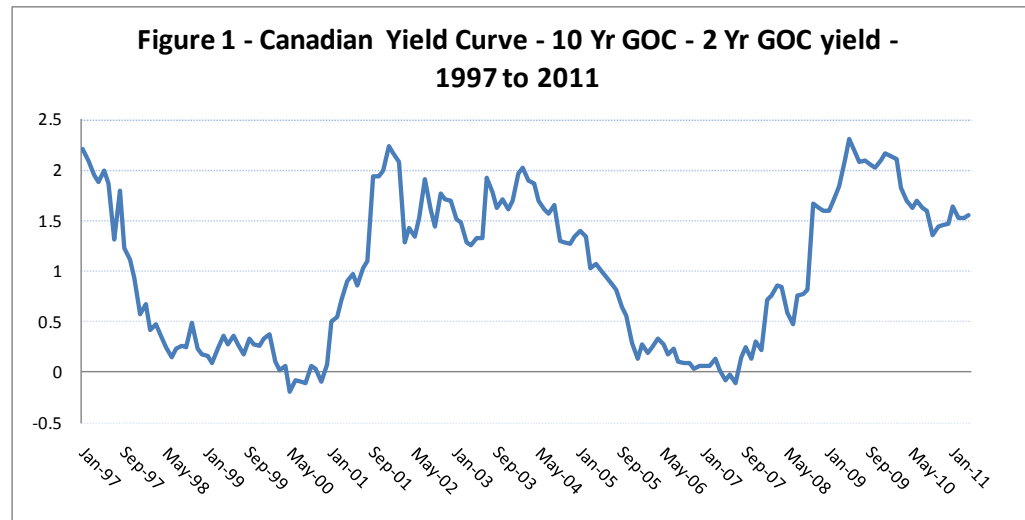
The current bull market, which began at the start of the 2nd quarter of 2009, has followed a pattern fairly similar to past stock market recoveries. The current bull market has been driven by several key factors including a rebound in global economic growth, extremely accommodative monetary policy and depressed valuations. This of course is the fuel that drives virtually all stock market recoveries. The prominence of each of these factors tends to be the greatest at the start of each recovery and therefore weakens as the bull market advances, but these factors tend to persist for years nonetheless.

When discussing market cycles, a good analogy for understanding the stock market cycle is to think in terms of innings in a baseball game. Using data from the United States S&P, we note that there have been 11 bull markets since WWII. These bull markets have averaged 56 months in length (from trough to peak), but it is worth noting that the longest bull market lasted almost ten years while the shortest lasted less than two. I estimate that we are currently 24 months into the current bull market which in baseball terms suggests that we are somewhere near the end of the 3rd inning or start of the 4th inning of the game, if this bull market turns out to be typical.

My assessment of where we are at in the current bull market does not involve much rocket science – I am simply comparing the length of the current bull market to past ones without making any judgment as to whether this one will be longer or shorter than past cycles. However, it is worth noting that BCA Research (BCA), the only paid research publication we subscribe to, assesses the current bull market to be at roughly the same point. According to BCA the stock market cycle follows three distinct phases, with the first being recovery, the second being maturity and the final stage being the blow-off phase. In their view, global equity markets are probably in the midst of transitioning from the recovery phase (phase I) to the maturing phase (phase II). Once again, in

baseball terms this would imply that we are moving (approximately) from the third inning to the fourth inning.

Besides the length of the current bull market cycle, we see that other key factors also provide us with positive insights about the market. These include the slope of the yield curve (see figure 1), market valuations and leading economic indicators. These factors all suggest that the explosive gains for the stock market that occurred in the first few innings of the current bull market are now behind us, but that there are no signs of a major market downturn in the offing. These factors can of course change quickly but for now our best guess is that the current bull market probably has another three years to go.



Waiting for the perfect pitch

Many baseball fans consider Ted Williams to be the greatest baseball hitter of all time. While the likes of Hank Aaron, Babe Ruth and Barry Bonds all hit more home runs over the course of their careers than Williams did, none had a batting average anywhere near as high as his. Williams reduced hitting to a systematic process which he shared in his legendary book, *The Science of Hitting*. I will assume that few of my readers are serious enough students of baseball to read this book but in essence Williams deduced that pitches that came in at certain levels in relation to the center of the strike zone (high and outside for instance) were statistically not worth swinging at. Williams therefore was always waiting for the perfect pitch. As such, Williams's contribution to his team over the years did not simply come from the balls he hit which were many. By avoiding "garbage pitches" he was able to stay at the plate longer, raising his chances of getting a perfect pitch, and if nothing else he was able to help his team by amassing more walks than any other player in his day. Besides his superb batting average Williams' "on base percentage" was 0.551, a record that stood for 61 years.¹

¹ How to Pick Stocks like Warren Buffett by Timothy Vick, pp93-94, McGraw Hill, 2000.

Moving away from Ted Williams batting statistics for a moment, it is interesting to note that Warren Buffett has been and remains a huge fan of both baseball and of Ted Williams. Buffett has repeatedly referred to Williams' process of thinking about hitting in baseball and applied that to the investment process. At the core of Warren Buffett's approach to investing is the belief that one should focus on a small group of superb companies with enduring long-term strengths and prospects. Companies like these are what Buffett would describe as "the perfect pitch".

So how does one find the perfect pitch? In our last newsletter we explained our process of screening for companies that enjoyed both 1) a high return on equity and 2) a modest valuation in relation to its peers and the market. Put another way, we view the perfect pitch as a company that simultaneously possesses a top quartile return on equity and a bottom quartile valuation. This process will lead an investor to a very nice list of potential investments. However, there is more to this process which I will expand upon shortly.

Albert Einstein was a baseball fan

Any of us who are even reasonably financially literate will be familiar with the concept of the magic of compounding. Evidently Albert Einstein described compound interest as "the greatest mathematical discovery of all time". However, while most of us are familiar with the magic of compounding as an intellectual idea, the true believers in the concept are those who have had the good fortune and patience to own an asset or investment that has compounded at a reasonable high rate over several years. Like Bo Jackson, those investors "know" the magic of compounding.

In order to find a great compounding asset or investment we need to know what we are looking for, i.e. before we swing at the perfect pitch, we need to know what the perfect pitch looks like in the first place. My definition of the perfect pitch in the form of a stock investment includes the following attributes;

1. The return on average equity (ROE), which is the annual return on the Company's equity capital, must be greater than 15%
2. This above average ROE must not be the result of excess leverage or accounting gimmickry
3. The above average ROE must be relatively stable from year to year.

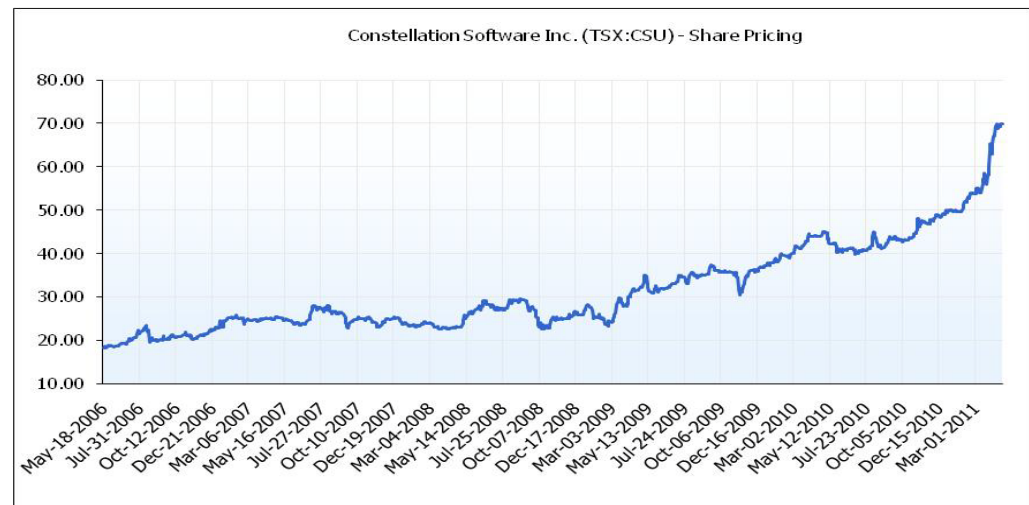
So why are these factors so important? The 15% return hurdle should be pretty obvious – if you can own an investment that over time can grow at 15% per annum or better then in a relatively short period of time you will achieve all of your investment goals. The second point is a little more subtle. While a high ROE is highly desirable, we want to make sure that the ROE is "good ROE" which is a function of the competitive advantage of a company's products or services and not "bad ROE" which comes from excessive use of leverage or accounting gimmickry. Finally, in order to get the "magic" part right, you need to find companies that will enjoy the high growth rate for years to come.

The last sentence of the previous paragraph sounds simple enough but it is an absolutely essential part of the “magic of compounding” story. In our view, the companies that can compound their earnings at greater than 15% for years must have two key things happening within their business model. The first is some sort of competitive advantage that prevents competitors from driving down prices and therefore allows the company’s profit margins to remain relatively high (high profit margins drive virtually all high ROE models). The second is the existence of a capital allocation model or process which allows companies to readily deploy the money that it has just earned into next year’s operations at a level that ensures that the ROE remains high. This sounds easy in theory; however only exceptional companies do it for long periods of time. These are the “perfect pitches” of the investment world.

Baseball season in Canada

Investors in Canadian equities should build their long-term strategy around a core group of outstanding companies that appear to be “perfect pitches” – that is stocks that can compound for a long time. As we enter the second quarter of 2011 we would like to provide you with an update on a few of what I consider to be “perfect pitches” in our portfolio.

Constellation Software (CSU) – has long been one of our most favored stocks because of its ability to create massive value for shareholders – the Company possesses both high margins and a superb capital allocation process. However, it should be noted that the Company has recently announced that it is examining strategic alternatives. This could mean that the Company is up for sale, going private or about to engage in a massive share buy-back. Regardless, the stock could very well be on its last lap which we expect should be a very exciting one. Constellation Software is our largest position in the Capital Ideas Fund and we are not sellers at current levels.



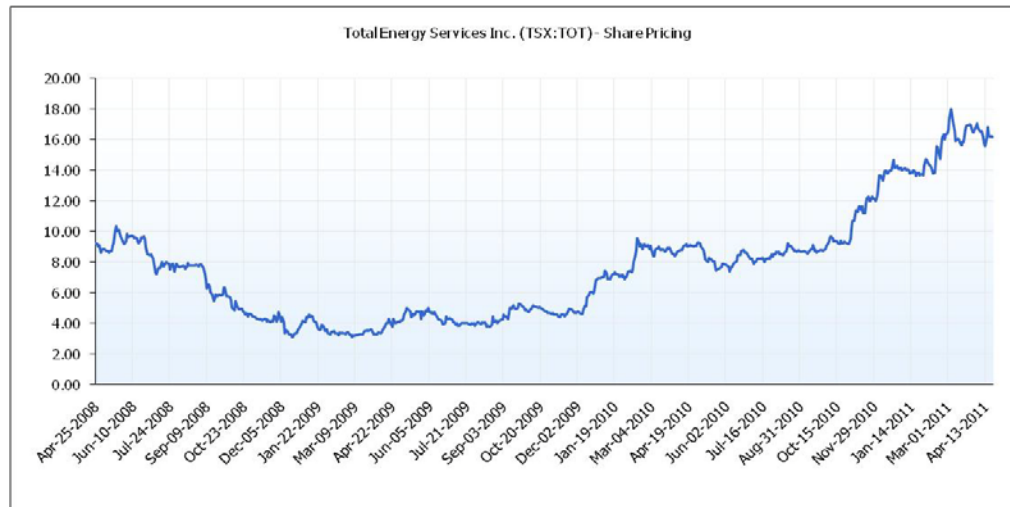
Paladin Labs (PLB) – is the second largest position in the Capital Ideas fund and for good reason. If we adjust for cash, the Company is earning an ROE of close to 40% with no signs that this rate of return is diminishing. The company also boasts an incredibly strong balance sheet and net cash balances could exceed \$10.00 per share at the end of Q1/2011. Like all perfect pitch stocks, Paladin simultaneously enjoys high margins and a superb capital allocation process. As Chris Berman of ESPN likes to say, “This one could...go....all...the...way!”



Home Capital (HCG) – all signs point to another solid year for Home Capital and the mortgage lending industry. The only small hiccup that industry participants like Home Capital might face is the confusion that might occur as it shifts from the old accounting standards to the new IFRS rules starting in Q1/2011. That said Home Capital has made a good effort to speak with the analyst community ahead of its next quarterly results so we are expecting a smooth transition. Home Capital has had an ROE in excess of 20% for 13 consecutive years and we expect that winning streak to easily extend to 14 years in 2011. Now that’s magic!



Total Energy Services (TOT) – if you are going to own a high ROE stock that is cyclical then you want to make sure that the good years make up for the bad years. Total Energy Services is a growth oriented services company and enjoys one of the best ROE track records in the industry. The Company is also a superb asset allocator and is renowned for being extremely astute acquirers. Total’s long term ROE has exceeded 20% per annum over the past decade. We think energy services companies will report huge profits this year and Total remains one of the most attractively priced in the group.



Closing thoughts

The Donville Kent Capital Ideas Fund was up 6.9% in the first quarter of 2011 and the Financial Services Venture Fund was up 7.3% over the same time period. We continue to patiently wait at home plate for those perfect pitches that we know are out there. Call me if you want to chat – *JP Donville* – 416-364-8886.