"Price is what you pay. Value is what you get."
Warren Buffett, 2008 Berkshire Hathaway Chairman's Letter

Third Quarter 2015 Commentary

Good Opportunities Fund

Dear Valued Client:

The Fund returned -1.1% over the third quarter of 2015, and is up 1.3% year-to-date. For year-to-date comparison purposes, the S&P/TSX Composite Index is down 7.0% while the S&P 500 Index is off 5.3%. During the quarter, we purchased a new company and closed out two successful short positions. The Fund has an 87% market exposure and holds 8% cash.

Our holdings' underlying operating results were very strong and, in nearly all cases, revenues and earnings have grown. We will continue to invest in businesses that have lasting competitive advantages and runways for future growth. Our investment process, which identifies and invests in the best 10 to 15 businesses we can find, has continued to preserve and grow our clients' capital.

Paying up is value

People often think of value investing as the discipline of buying "cheap" stocks, usually measured by low price-to-cash-flow or price-to-earnings ("P/E") ratios. However, these backward-looking ratios value companies based on what has happened and what earnings were; not what they are going to be. The current price of a business may reflect "value" regardless of these metrics.

Consider this real-life example of an investment opportunity that existed years ago. On October 3, 1974, the S&P 500 Index closed at 62, a low, during a severe bear market. The S&P 500, at that time, traded at a P/E ratio of only 6.9 times. On that day, the shares of Wal-Mart Stores, Inc. closed at $12. With earnings per share of slightly less than a dollar, the P/E of Wal-Mart's stock was 13 times, almost double the wider market.

From that day in October 1974 to today, the S&P 500 has produced a return of 12% per year (including dividends). A $100,000 investment in the S&P 500 would have grown to $9 million today (all figures are in USD). Had you instead invested in Wal-Mart, the same $100,000 investment would be worth $400 million today, with annual dividends exceeding $12 million. Pause here to reflect on the sheer magnitude of the growth that Wal-Mart provided to early investors.

Paying 13 times earnings does not seem like a very high multiple for a stock like Wal-Mart's. But remove yourself from today's multiples and consider the market environment at the time. In 1974, inflation and interest rates were near 10%.

So, what was the stock really worth if one had perfect forecasting ability? To buy Wal-Mart and generate the same 12% performance each year as the S&P 500, you could have paid $600 for a share of Wal-Mart. That equates to a P/E of more than 600.

Imagine how it feels paying even double the S&P 500 P/E multiple for a stock. Anchoring to the market's P/E ratio as the barometer for value certainly makes you feel like you are taking excessive risk and could make one feel very foolish.

The P/E ratio is just one metric in valuing a company. Other factors, like a company's growth rate, market position, return on incremental invested capital, capital structure, and management play important roles in valuing a business. Very little can be ascertained simply from the P/E ratio of a stock.

On the flip side are companies that appear to be selling at low P/E ratios relative to the market. On the first day of 2015, Viacom Inc. traded at $75. Viacom is the owner of cable networks such as MTV, Nickelodeon, BET, Comedy Central and others. Viacom reported earnings per share for its fiscal year ended September 30, 2014, of $5.81. The S&P 500 was trading at 20 times earnings and the stock was selling at a very cheap 13 times earnings. Today, the stock is at $47, a 37% decline from the beginning of the year.

Viacom is a company that, despite being "cheap" by quantitative metrics, had rapidly deteriorating viewership and programming quality that had fallen as a result of the loss of important on-screen talent. Additionally, channels that were positioned in the teen demographic – where video viewing habits have been changing rapidly – have suffered from decreased viewership. What appeared to be a cheap stock was actually quite expensive given the company's deteriorating industry positon.

Value investors are lumped together and seen as stylistically distinct from growth investors. The truth is a company may grow and, if that growth is achieved at high rates of return on capital employed, that company is more valuable than one that is stagnant or facing obsolescence.

At GFI, we do not equate a low P/E with a good investment. Our job is to purchase companies with competitive positions that make growth a near certainty for years to come, as well as to make sure we pay a reasonable amount for that growth. As Buffett said best, "Price is what you pay. Value is what you get."

Thank you for your continued support. We are always available if you would like to discuss your investments or any other matter.

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Source: Philosophical Economics, Wal-Mart's 1974 Annual Report: Sometimes You Get What You Pay For, March 22, 2014, http://www.philosophicaleconomics.com/2014/03/wmt/

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