GFI Investment Counsel Ltd.

Preserving and growing family capital™

"Diversification is protection against ignorance. It makes little sense if you know what you are doing."
Warren Buffett

Fourth Quarter 2015 Commentary

Good Opportunities Fund

Dear Valued Client:

The Fund gained 6.6% over the fourth quarter of 2015, and closed the year up 8.1%. For comparison purposes, the S&P/TSX Composite Index closed the year down 8.3%, while the S&P 500 Index gained 1.4%. During the quarter, we purchased two new companies for the portfolio, closed out a long-time holding and eliminated a successful short position. Our unwavering focus on well-financed companies with sustainable business models helped us to avoid industries that underwent significant upheaval throughout the year. At year-end, the Fund had roughly 92% market exposure and held 4% cash. Further information on the Fund, as well as its historical performance, can be found on our monthly fund update sheet.

We are pleased to inform our unitholders that as of January 1, 2016, the Fund has instituted a 6% hurdle rate. This change means that a performance fee will only be earned if unitholders first receive a 6% return, net of management fees. We made this change in response to our firm's asset growth, which has allowed us to pass along favourable economics to our unitholders.

Balance Sheet Strength

At GFI, we continuously monitor balance sheet health in our analysis of potential new investments, as well as when we are reviewing our existing holdings. With today's low interest rates, many companies make use of high levels of debt to buy back their stock and to fund corporate acquisitions. This practice, taken to extremes, can lead to excessive debt and unnecessary risk for a company's shareholders.

We are extremely sensitive to excessive debt in certain industries, especially those industries that are prone to disruptions stemming from technology advancement. If a company suddenly finds itself in a position where a strategic shift is required, a cash-rich balance sheet provides management with time to execute a new plan and invest accordingly. However, if a company already carries a high amount of debt, capital for investments may be lacking and lenders may demand repayment for their loans at very inopportune times.

Consider the example of Weight Watchers. Weight Watchers is a 50-year-old diet and weight management program that has not changed much since it was founded. Historically, the company was quite successful; 2012 was a record year for the company, with earnings exceeding US$250 million. Given its strong earnings, the company decided to borrow over US$1.3 billion to buy back stock.

In the following three years, Weight Watchers faced fierce competition from simple and free smartphone apps. During that time, earnings collapsed and the company's debt became nearly unmanageable. The stock fell from US$75 in early 2012 to roughly US$5 by mid-2015. Any value that equity holders originally had was eclipsed by the sheer amount of debt. A strong balance sheet would have given Weight Watchers time to alter its strategy. Instead, its magnified debt load caused massive stress on the company and investors became rightly concerned with the threat of bankruptcy.

Indigo Books and Music faced a similar challenge in the last half decade. Physical books, magazines and textbooks were being replaced by tablets and e-Readers. Under the leadership of Heather Reisman, however, the company has historically maintained a cash-rich and debt-free balance sheet. Since roughly 2009, and as physical books sales have been declining, the company has closed unprofitable stores, experimented with its own e-Reader (Kobo, which has since been sold), and launched an online bookstore. Indigo has invested significantly in its stores by adding cafés, and has become a gift and boutique retailer in addition to selling books. Today, physical book sales are 65% of company sales, and non-book sales are growing quickly – and offering healthy margins.

This strategic shift took the company nearly five years to complete and included a span of time in which the company had almost no profitability. The shift was made possible because management did not overburden the company with debt that would have restricted its ability to adapt to a new environment. The story of Indigo Books is evolving and not yet complete. A healthy balance sheet and adaptive management will continue to help maneuver the company through future change. Although a healthy balance sheet alone is insufficient to ensure a company's survival, it provides management with time and capital to execute a plan. Time is often the difference between success and failure.

Different circumstances and industries require different financing structures, and no one rule governs all businesses. However, conservative financing in industries that are more susceptible to change will lower equity risk and provide higher long-term returns. For this reason, an appropriate level of debt is paramount when GFI analyzes current and potential portfolio investments.

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

Wishing you and your family a healthy and happy 2016 and beyond.

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FINANCIAL POST

Why portfolio diversification is overrated or 'protection against ignorance'

December 30, 2015 — By Jonathan Ratner

'Diversification is protection against ignorance. It makes little sense if you know what you're doing,' says investing guru Warren Buffett. Besides...

You don't have to be Warren Buffett to build a concentrated portfolio of stocks that outperforms the market, but you do need to adopt some of his investing strategies.

The world's most famous investor has many notable quotes that both retail investors and some of the biggest money managers around rely on to guide their decisions. One of them focuses on narrowing your investment choices: "Diversification is protection against ignorance. It makes little sense if you know what you're doing."

The case for a concentrated portfolio – whether that's just 10 stocks or closer to 30 – can be summed up rather easily. When a portfolio manager or individual investor holds say 40-plus stocks, probably no more than a dozen are their best ideas. The remainder are filler, perhaps intended to protect the portfolio through diversification, but instead serving to water down its returns.

Charles Ellis, a prominent consultant and professor, put it best when he said, "increasing the number of holdings dilutes our knowledge, disperses our research efforts, distracts our attention, and diminishes our determination to act – when really called for – decisively and with dispatch. If you work hard enough and think deeply enough to know all about a very few investments, that knowledge can enable you to make and sustain each of your major investments with confidence."

Studies dating back as early as 1968 are frequently cited by investors making the case for concentrated portfolios. Way back then, Evans & Archer found that stock-specific risk can largely be eliminated by holding approximately 15 stocks.

In 1970, Fisher & Lorie found that 80 per cent of risk can be eliminated by holding eight stocks, and 90 per cent by holding sixteen stocks.

This stands in stark contrast to modern portfolio theory, which states that a more diversified portfolio leads to less risk from each of its components.

More recently in 2014, CIBC World Markets published a report that looked at historical returns for 1,000 randomly selected portfolios between August 2003 and October 2013. The results lined up with previous research, showing that average volatility declines steadily until portfolios hold approximately 15 stocks. Adding more names to the portfolio after this point, produced virtually no further risk reduction.

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However, quantitative analyst Jeff Evans noted the flaw in most diversification studies. That is, they assume portfolios are selected entirely at random.

That's why having the right strategy - such as those utilized by the likes of Buffett, George Soros and Martin Whitman – comes in.

"A concentrated portfolio goes hand in hand with your investment approach," said Effie Wolle, chief investment officer at Toronto-based GFI Investment Counsel. "If you're investing in the tech sector where things change month-to-month and year-to-year, a concentrated portfolio probably doesn't make sense. On the other hand, if you're investing in carefully selected businesses with modest leverage, and you can see them being around for 20 or 30 years, then a concentrated portfolio makes a lot of sense."

The notion of being a business owner when you buy a stock is something common to those, like Buffett, who use the concentrated approach.

Wolle, who typically owns 15 to 20 names for his clients, stressed the importance of taking your time and getting to know a business before putting money into it. After all, it's hard for anyone, even with a army of analysts, to keep track of 50 or 100 companies and know them intimately.

David Barr, chief investment officer at Vancouver-based PenderFund Capital Management, usually owns 20 to 40 stocks in his portfolios.

He also has a longer-term approach to his investments, and looks at a stock as if he's buying the entire business.

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"For some people, a stock is just three letters on a screen. It's like being an ETF, which doesn't care what the business risk is," Barr said. "Our 100th best idea isn't all that good. We'd much rather continue allocating capital to our best ideas, where we have a much higher level of conviction and understanding."

He focuses on companies with a sustainable competitive advantage. These high-conviction names get a higher grade because they are poised to dominate their respective markets five to ten years out.

Of course, investors must track what these companies are doing to deepen that competitive advantage and what the external threats are that may knock them back.

Barr also looks for businesses in large and growing markets, so they have a long runway of healthy returns ahead. "Businesses that meet this criteria are more predictable and have a lower chance of something sideswiping them, which might mean you lose half your money overnight," he said.

Investors need to remember that diversification isn't only sourced through from buying more stocks in a wider variety of sectors. It also comes from a better understanding of a business.

For example, an information technology company may get half of its revenue from the oil and gas sector. So while it's categorized as a tech stock, what really matters to its business is the end customer. That's where the real risk lies.