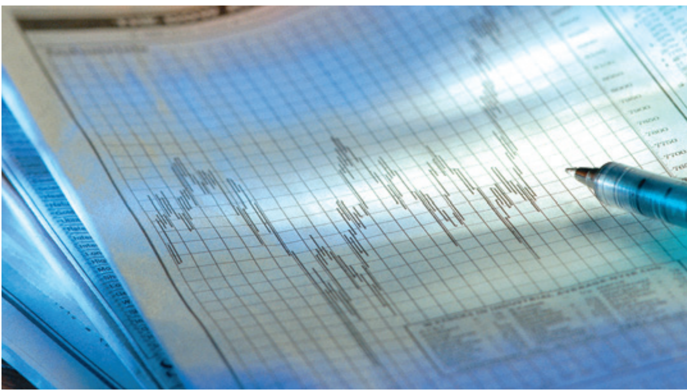
GFI Investment Counsel Ltd.
Preserving and growing family capital™

GoodQuarter

AUTUMN 2015



IN THIS ISSUE

› **The Buffett Fishing Hole**
We believe we are succeeding in our effort to adhere to the investment approach of Berkshire Hathaway.

› **Paying Up Is Value**
Very little can be ascertained simply from the P/E ratio of a stock. At GFI, we do not equate a low P/E with a good investment.

"Price is what you pay. Value is what you get."

— Warren Buffett, 2008 Berkshire Hathaway Chairman's Letter

Dear Valued Client,

In our spring 2015 quarterly commentary we wrote, "As the proverb states, you need to make hay when the sun shines, and since we don't know when the sun will shine, always be in a position to make hay. And know that occasionally it will indeed rain." This proved to be very prophetic, as equity markets fell around the globe over the period.

In the third quarter, GFI's equity positions achieved moderate investment returns. Conversely, our fixed income holdings decreased slightly. Our holdings' underlying operating results were very strong and, in nearly all cases, revenues and earnings continued to grow. 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 15 to 20 businesses we can find, has continued to preserve and grow our clients' capital.

The articles in this issue of our newsletter discuss a trend that has emerged where Berkshire Hathaway has purchased three of our last 20 portfolio companies, as well as the concept of paying what appears to be expensive prices for strong businesses.

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

Daniel Goodman, CFA
President and
Chief Executive Officer

Effie Wolle, CFA, MBA
Chief Investment Officer

The Buffett Fishing Hole

Since GFI's inception, our investment approach has been to emulate the style of Warren Buffett and Charlie Munger of Berkshire Hathaway Inc. While we have been very pleased with our investment results, we take pride in the fact that Berkshire Hathaway has purchased three of our holdings in the past three years. Given that there are thousands of public companies to choose from, and that we only invest in 15 to 20 of those businesses, we believe we are succeeding in our effort to adhere to the investment approach of these two investing legends.

In February 2013, Berkshire Hathaway, along with 3G Capital, made a bid to purchase all the outstanding common shares of H.J. Heinz Company. This bid was ultimately successful. Heinz was a very successful investment for GFI, increasing in value while paying a dividend of roughly 4%.

In August 2014, 3G Capital, with the financial backing of Berkshire Hathaway, announced the proposed (and ultimately successful) purchase of Tim Hortons Inc. by Burger King, a company controlled by 3G Capital. Tim Hortons generated excellent returns for GFI, and the company continues to perform admirably for our clients' accounts — as we were able to maintain an investment in the combined public company.

In August 2015, Berkshire Hathaway announced an offer to purchase Precision Castparts Corp. ("Precision"). We purchased Precision for client accounts in June of 2015, and the company became one of the shortest-held investments in GFI's history when, only two months after its purchase, we sold our shares of Precision near Berkshire's offer price.

In all three cases, GFI followed a rigorous approach to identifying businesses that have competitive advantages and runways for future growth. We continue to invest in the same manner and believe that, whether or not our holdings are bought by Berkshire or any other purchaser, growth in earnings and dividends will result in increased equity value. ■

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, where programming quality has fallen as a result of the loss of important on-screen talent.

continued on page 4

Paying Up Is Value *(continued)*

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." ■

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/

GFI Investment Counsel

GFI Investment Counsel ("GFI") provides tailored investment portfolios to families, foundations, trusts and corporations. We work closely with our clients to customize investment accounts that coincide with our clients' unique requirements. GFI focuses on preserving and growing client capital through intense due diligence, focus, and discipline.

In January 2008, GFI launched Good Opportunities Fund ("the Fund"), an alternative investment fund available to accredited investors. The Fund focuses on a select group of investment opportunities that provide an attractive risk/reward dynamic regardless of asset class or market capitalization. The Fund is managed with a focus on understanding the businesses, their capital structure, and risks and opportunities.

For more information about GFI Investment Counsel or the Good Opportunities Fund,
please call **416.488.8825** or **email info@gfiic.com**.