

The Perspective

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Do You Have The Right Heroes?

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foundations, and select institutions. We
are focused on preserving our clients'
capital and growing it over time.

We utilize a rational and rigorous
process to find, analyze, and select
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SILVER HEIGHTS
CAPITAL MANAGEMENT

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Do You Have the Right Heroes?

When we were kids, we all had heroes we looked up to. Oh, how we yearned to be like them. It might have been a sports star, a famous celebrity, or our big brother or sister. Whoever it was, we emulated their actions in the hopes of one day becoming just like them.

“Tell me who your heroes are and I’ll tell you how you’ll turn out to be.”

Warren Buffett

Human nature is such that we tend to imitate the behaviour of our heroes. Parents everywhere have known this for a long time, hence the importance they place on good role models in a child’s life, and their strong opposition to bad ones. Parents know that having the right heroes is an important influence on making good decisions and “behaving the right way”.

All this doesn’t change that much when we grow up (for those of us that do). The heroes themselves might change, but our nature – and our tendency to imitate – don’t.



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So why is this important in investing? Just as the hero of our childhood became the standard against which our actions and achievements were measured, as investors, our results are almost always measured against “The Index”. The index is a basket of stocks whose performance is meant to be representative of the performance of the stock market as a whole. What many investors don’t realize is that indices have a nasty tendency to invest the most money in the most overvalued companies – a tendency that doesn’t make for a good investment idol.

Market indices around the world suffered major declines in 2008. Emulating these indices was disastrous last year. If your investment results were eerily similar in magnitude to any of the major benchmarks, you may want to examine if you have been – knowingly or unknowingly – following a “closet index” approach. If so, perhaps you (or your hired money manager) have the wrong hero.

At Silver Heights, we believe that achieving excellent risk-adjusted returns requires an independent-minded approach, leading us to construct portfolios of stocks that may differ materially from the index.

How it’s done in the “real” world

In past *Perspectives*, we’ve talked about the importance of always incorporating the notion of risk when assessing the performance of your investment portfolio. Equally important is knowing – or at least having some idea of – what targets you are trying to hit.

Most investors reference their investing results to benchmark indices like the TSX Composite in Canada or the S&P 500 in the U.S. It is worthwhile having an understanding of how these indices are constructed because **significant** amounts of the money invested in stock markets around the world are managed with the goal of replicating the returns from such indices. Some of the investment dollars that are managed in this manner come in the form of low-cost index funds that have *explicit* mandates to copy the weightings of their respective target indices. In addition, though, there are many investment managers who

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profess to follow an actively-managed approach, but in reality, are “closet indexers” – managers who secretly target, to greater or lesser degrees, index weightings¹.

Even if you don't have your own standalone investment portfolio, this topic may still affect you: if you have a company pension plan or a group RRSP, there's a good chance that at least a portion – if not the majority – of your retirement assets are managed with the goal of mimicking one of these indices.

The Fallen Hero

From the perspective of a rational investor, the index is not an appropriate role model because of the way it is constructed. The reasons are as follows:

1. Indices are market-cap weighted.
2. The indices do not make a judgment on the value provided by a given stock, and in fact, often work counter to common sense: everything else being equal, the more expensive a business gets, the more weight it carries in the index. Similarly, the cheaper a business gets, the less weight it carries in the index.
3. Because of this flaw, indices do not give good risk-adjusted returns.

The TSX Composite and the S&P 500 are “market-cap weighted” indices. In simplified terms, this means that for those companies that are included in the index, a company's weighting in the index is based on its aggregate market value (total shares outstanding multiplied by the share price). If Company A is ten times as big as Company B, then Company A's weighting in the index will be ten times as big as Company B's weighting, *regardless of the other characteristics of the businesses*. If your portfolio mimics the index, then you have invested ten times as much in Company A as you have in Company B – not always a good investment plan. As we pen our thoughts, Ford Motor company has a market value of over (\$C) \$10 billion versus, say, Leon's Furniture, which is valued at just under

¹ Please refer to a previous edition of *The Perspective* entitled “Investment First – *The Untold Truth*” for a more detailed discussion on why investment managers may be unwilling to stand apart from the crowd. All of our earlier newsletters may be downloaded from our website www.SilverHeights.com.

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(\$C) \$700 million. Leon's, for those unfamiliar with the company, has a long and enviable record of profitability and growth and has no debt. In fact, they currently have over \$100 million of cash in the bank. Would you really want *more than ten times* as much of your portfolio invested in Ford as you would in Leon's? If they were in the same stock market index, that's exactly what would happen.

Yes, there *should* be a link between a company's market value and the quality of the underlying business. However, how much of your portfolio should be invested in a given company should not necessarily be *positively* correlated with that company's value in the stock market. In a market-cap weighted index, as a company's stock goes higher and higher, the greater its weighting in the index.

Imagine that you are the coach of a hockey team. You are deciding how much ice time to give to each of the players. Would you say to yourself, "I'm going to allocate ice time based on how much each player weighs"? Yes, there would be some relationship between a player's weight and his/her size and strength – both positive characteristics – *but only to a certain point*. It's more likely that you would also consider other characteristics such as speed, agility, work ethic, and playmaking abilities.

Looking back to the technology bubble of the late 1990's and the recent energy bull market in early-to mid-2008, it should be clear that the risk of capital loss increased as prices rose. The dramatic declines that followed those two bull markets should have driven home a tough lesson for investors: portfolio weightings should *not* be dictated solely by market values.

At the peak of the technology bubble, Nortel accounted for approximately one-third of the *entire* TSX index. This significant weighting was driven by an extreme overvaluation of that company's stock.

*If you accept the notion that there is a point at which a company may be overvalued, then a market-cap weighted index actually **increases** your risk as stocks overshoot their fundamental value.*

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Indices themselves are just mathematical constructs, dispassionate and objective. They do not claim to make any judgments, nor do they espouse any philosophies, investment or otherwise. However, as soon as an investment strategy explicitly or implicitly mimics or “tracks” an index, it effectively decides to:

- Buy all the companies in the index, good and bad, *at whatever price they are trading at;* and
- Invest the most money in the biggest companies, good and bad, *at whatever price they are trading at.*

By indexing, one eliminates the assessment of the value provided by a given stock, the quality of the business, and the risk inherent in investing in a given stock. One just purchases the stocks, *at whatever price they are trading at.* In a world where maximizing returns and minimizing risk are such important goals, bizarre is probably not too strong a word for this sort of thinking. What would your parents have thought if you chose your childhood companions based on an equivalently-strange train of thought?: “Mom, I’ve decided to be friends with *all* of the kids in school, including Jimmy, who steals bicycles, and Nancy, who cheats on her math tests. But, I’ve decided to spend the most time with George, because he’s bigger than anyone else in the school.”

The Alternative

*For any investor, individual or institutional, it makes much more sense to us to have more money invested in less expensive companies – **all else being equal** – rather than in more expensive companies.*

When we construct our investment portfolios, we at Silver Heights often think about each company along two parameters: quality and price. Based on our assessment of the business, we would calculate our estimate of the company’s value. Lastly, we would compare the price of the company’s shares in the stock market with our estimate of its value. The lower the publicly-traded share price is relative to our estimate of its value, the better. Simply put, this is value investing’s “buying a dollar for 50 cents”.

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Typically, there is a positive correlation between the two characteristics and, the higher the quality, the higher the price. However, imagine a situation where, after extensive research and study, you found a company that was of very high quality and, because of factors completely external to it, its share price was trading at a fraction of its true economic value.

In the fall of 2008, we saw many examples of share price declines in certain stocks that had absolutely nothing to do with the company's fundamentals. For example, many hedge funds used significant amounts of leverage (*i.e.*, borrowed money) in their portfolios and as some of the "bets" went against them, they received margin calls and were forced to liquidate many holdings on very short notice. In such situations, it is ironic that in order to raise the cash to meet the margin calls, these funds were forced to sell their very best companies first since many of the lower-quality companies went "no bid" (*i.e.*, they were virtually unsaleable at any price).

Under this scenario of high quality and low price, it would make sense that you would want a higher-than-average amount invested in these types of companies.

As a rational investor, your portfolio weightings should be heavily influenced by fundamentals. That is, the higher the quality of the company and the lower its price relative to its true economic value, the bigger its weighting should be in your portfolio.

At Silver Heights, the index is not our hero. Instead, we carefully assemble portfolios of select businesses, each chosen for their combination of quality and price.

By not blindly following the index, we can avoid the worst of the downturns when indices are overvalued and highly likely to plummet, as they did in 2008².

² In 2008, our approach allowed us to outperform the TSX Composite Index by well over 1,000 basis points. The preservation of capital – not losing money – is a cornerstone of successful investing. While everyone notionally understands that losses are a serious impediment to long-term wealth creation, most are not aware of the magnitude of the roadblock posed by "the math of losses": *e.g.*, a 20% loss requires a 25% return to break even whereas a 50% loss requires a 100% return to break even.

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Which way to the finish line?

Goal setting is an important exercise. Whether you are talking about life or business, it is useful to have an idea of the general direction you would like to go. With investing, it is unfortunate that many investors don't take the time to thoroughly think through their financial objectives. When investors do review their portfolios and investment results, the most common return comparisons are made against widely-followed benchmark indices like the TSX Composite in Canada or the S&P 500 in the U.S. This is a simple comparison to make, but one that may not be the most appropriate for investors who are concerned about risk-adjusted returns. For example, in bull market years, you shouldn't necessarily feel bad that your portfolio's return lagged the index, given that the index's return – quite likely driven by having the highest weighting in the most overvalued companies – may not be a good risk-adjusted benchmark.

While we are not advocating completely disregarding how the market as a whole performs, it is important for investors to have an understanding of how indices are constructed and how the various companies' weightings are determined within those indices. The inherent risks from their construction methodology may not be something that is consistent with your personal investing goals and risk profile.

"The Index" just might not be the right hero for you.

Sincerely,



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