# The Perspective

Rational, independent thinking™

# Don't Judge A Book By Its Cover

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Silver Heights Capital Management Inc. is a discretionary investment counsellor.

We manage money for affluent families, 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 investments for our clients.

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# Don’t Judge A Book By Its Cover

In a perfect world, we would all be judged on merit, and appearances wouldn’t matter. Unfortunately, this isn’t the case. Appearances do matter, and in fact, can sometimes be deceiving.

In the 1960s and 1970s, there was a popular game show called *Let’s Make A Deal*. In the show, contestants chosen from the audience were given a prize, and then offered the chance to trade that initial prize for another. But, there was a catch. The “trade-up” item was concealed. It may have been hidden behind one of three doors on the stage, or it may have been covered by a pretty, gift-wrapped box on a table. Sometimes, there was a very valuable prize under wraps, or other times, it could have been just a raw egg. Contestants had to make their decision without knowing what they were getting.

When it comes to the investing world, Wall Street and Bay Street are masters of packaging and selling tidy financial products to the masses. And, just like on *Let's Make A Deal*, financial consumers often don't know what they are getting in their investment package.

> *One of the keys to investing success is to be able to look at an investment, "look through the structure", and assess the merits of the underlying asset.*

Financial history abounds with outrageous and misleading financial packaging. In recent years, the mortgage-backed security ("MBS") fiasco in the U.S. was perhaps the most publicized example of an attractive exterior concealing a rotting interior. Michael Lewis' book, *The Big Short*, is a fascinating tale that documents the rise and fall of the MBS market. One of the most interesting aspects of that story was how a few small groups of individuals – against commonly-followed practice – took the time to look through the elaborate, elegant structure put forth by Wall Street to see the risky nature of the underlying assets, and how they benefited by not being fooled by the packaging.

Although the MBS disaster was an extreme example of a misleading exterior, there are a few examples that are closer to home where being cognizant of the packaging may be worthwhile.

It is not uncommon for many investors to have their money invested in a number of mutual funds. This strategy of diversifying their capital into more than one fund seems prudent. But, are they really achieving their goal? While this characteristic may not be true in all markets, in Canada, we have a less-broadly diversified stock market index than most other countries. As a result, if an investor held three or four "Canadian Equity Funds", it would not be at all surprising to see a significant overlap in the funds' holdings and the apparent diversification would be far, far less than the investor might think.

At a certain point, owning more and more funds would result in the investor, in essence, owning the index. If that were the case, the investor would be better off to buy a low-cost index fund rather than owning the more expensive basket of mutual funds.

With direct stock investing, at one end of the risk spectrum is a single-product business with one or two large customers. An example of this situation might be an auto parts manufacturer, who made a limited number of parts, and who sold their product to only GM. The loss of their one customer, or a change in technology impacting the demand for their product would be devastating to the business.

Not wanting to highlight only negative examples of financial offerings that present downside risks to investors, there are a few stock-specific examples of where a seemingly risky package is actually far less risky than appearances would suggest.

Commonly-followed financial wisdom dictates that holding a single stock is very risky. However, as we highlighted above, it's not the "single-stock" nature of the investment that makes it risky. It's the underlying asset or assets.

In contrast to a single-product, single-customer business, ownership of a single stock which happens to be a holding company can be far less risky than most would think. One of the most prominent examples would be Berkshire Hathaway, a holding company which is a very broad collection of businesses ranging from insurance, to railroads, to a multitude of manufacturing enterprises.

Here in Canada, there is a publicly-traded software holding company called Constellation Software that sells specialized software to over 50 different industries in over 30 countries. Their 30,000+ customers include public transit operators, real estate brokers, agricultural equipment dealers, fitness clubs, and water utilities, among dozens of others. If you invested 10% of your portfolio in a company like this, the underlying collection of businesses you'd own would be very diversified. On the surface, though, a 10% position would be far larger than most investors, particularly institutional ones, would think prudent. Constellation could, in theory, split itself into four companies that each operated in 13 or 14 industries. If they did that, and you invested a total of 2.5% into each of these companies, for a total of 10%, would your underlying economic exposure be that much different than when it was one company and one stock?

## Think Like An Owner

Although it is often forgotten in today's world of real-time, all-the-time news and stock market speculators that trade stocks every few seconds, never forget that when you own a stock, you own a piece of a real business. It's no different than owning the local gas station or convenience store. Which of the following two collections of businesses is less risky, the 3-stock portfolio or the 12-stock portfolio?

| 'Less' Diversified<br>3-stock portfolio |
|---|
| Disney |
| UPS |
| Johnson & Johnson |

| 'More' Diversified<br>12-stock portfolio | |
|---|---|
| Barrick Gold | Kinross Gold |
| Goldcorp | Gold Fields |
| Newmont Mining | Eldorado Gold |
| Newcrest Mining | Polyus Gold |
| AngloGold Ashanti | Harmony Gold |
| Yamana Gold | Freeport-McMoran Copper & Gold |

Your risk as an investor comes from the economic asset that underlies your investment. Don't let the packaging obscure the facts. It's always important to look beyond the cover to discover what lies beneath the surface. That's what will ultimately drive your investment results.

Sincerely,

Lung-Ming Lam
(416) 342-5626

Kevin Kuebler
(416) 342-5625

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333 Bay Street – Suite 1140, Toronto, Ontario M5H 2R2 | www.SilverHeights.com