The Perspective

Rational, independent thinking™

The "Best" Returns *Part I*

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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.

Silver Heights
Capital Management

www.SilverHeights.com

The “Best” Returns
Part I

Happy New Year! As we begin another year, we at Silver Heights – like most investors – will reflect upon our investment returns of the past year. But unlike most investors, we do not blindly accept that the best returns are simply the highest returns. As we all look back upon our investment achievements of the past year (and, hopefully, not too many mistakes), we think that it is important to consider not only the absolute level of returns achieved, but also the level of risk faced in order to achieve those returns.

We believe that investment returns should *always* be viewed in relation to the risk level of the investments within your portfolio. We doubt that many people would say that a 5% return from the stock of an early-stage technology company – with all the risks entailed therein – would be "better" than a 4% return from holding cash. Why is this higher return not better than the lower? Because the meagre 1% of extra return does not adequately compensate for the significant additional risk that was faced. The return portion of the equation is easy to understand but, unlike the example above, in most circumstances the risk component is less clear.

Risk is one of the key concepts that must be understood if one is to become a successful investor. Many would even argue that understanding risk is *the* fundamental idea behind investing. There are many ways of thinking about risk and returns, and our thoughts on these two concepts form the foundation of Silver Heights' investment philosophy.

> *At Silver Heights, we never think of returns in isolation.*
> *We only think about returns on a risk-adjusted basis.*

What is "risk"?

Assessing risk is challenging. Even when a risk is recognized, it can be difficult to fully describe or articulate, and risk is notoriously problematical to measure or quantify. By far, the most commonly-referenced definition of risk in the investment industry is volatility – the more volatile an investment's market price, the riskier it is deemed to be. This notion comes from the academic world and is elegant in that volatility is precisely measurable. ***If*** one accepts the argument that risk equals volatility, the difficulties of measuring and quantifying risk conveniently fall away.

At Silver Heights, we strongly disagree with this definition of risk. In our opinion, precision is no substitute for correctness. That is, the precision and convenience afforded by thinking about risk as volatility is no substitute for a more correct way of thinking about risk, even if risk is less precisely quantifiable under our alternative methodology.

The risk-equals-volatility framework would conclude that a company whose stock price fluctuated from $50 to $40 to $30 is now more risky – because of its volatility – than if the company's stock remained at a constant $50. We would argue that paying $30 per share is better than paying $50 per share for the same business, and much less risky from the perspective of losing the money we invest.

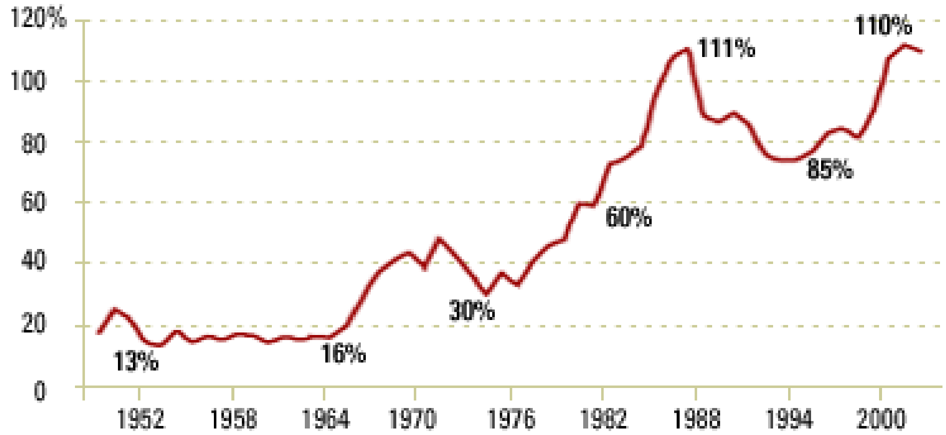
> *From a common-sense perspective, we think that most rational people would define investment risk as being related to the likelihood of losing money. That's how we think about risk at Silver Heights: "What is the chance that we, and our clients, could lose our hard-earned money in a particular investment?"*

So, how does the commonly-held belief that risk equates to volatility relate to losing money, and why is it that so many people think of the two as being the same?

The importance of time horizon

Today's investing climate is one that is becoming increasingly short-term in focus. "Turnover" is the statistic that indicates how much trading occurs in an investment portfolio. It is the dollar value of stocks sold divided by the average portfolio size in a year. This number is important because the inverse of the turnover ratio tells you how long, on average, a stock is held in a portfolio. For example, a 50% turnover indicates that a portfolio holds its stocks for an average of two years while a 100% turnover ratio indicates an average holding period of one year.

U.S. Mutual Fund Turnover



Source: Bogle Financial Markets Research Center

As we can see from the chart above, over the past four decades, the average holding period for U.S. mutual funds has decreased from over 6 *years* to about 11 *months.* We think it's incredible that the U.S. mutual fund industry holds its average stock for less than one year.

> *"If a six-year holding period can be characterized as long-term investment and if an eleven-month holding period can be characterized as short-term speculation, mutual fund managers today are not investors. We are speculators."*
>
> John Bogle, founder of The Vanguard Group

As investment time horizons for many have become shorter and shorter, we would agree that the degree to which a stock's *price* bounces up and down (*i.e.*, volatility) becomes more relevant. At the extreme, a day trader with an investment time frame of hours or even mere minutes will be far more concerned about stock price volatility than business fundamentals. Because he has to sell the stock today, only today's price matters to him.

In contrast, we firmly believe that the ownership of equities should always be viewed with a long time horizon. Therefore, the risk that stock price volatility presents over the short term becomes almost irrelevant. We believe that this shorter-term risk can be largely eliminated with proper asset allocation. By having a sufficient reserve of cash on hand to take care of one's cash needs in the near term, you can eliminate the risk of having to sell in the short term when unfavourable pricing may prevail.

> *If you eliminate the possibility that you may need to liquidate a stock on short notice, short-term price volatility becomes a non-issue.*

Stock price volatility is a fact of life and *all* publicly-traded companies will experience – at one time or another – stock price swings that are completely unrelated to the underlying operations and economics of their businesses.

> *A beneficial corollary for the long-term investor is that, because so many investment managers are so short-term focused, stock prices will most certainly deviate from long-term business values. In other words, there* ***will*** *be times when a company's stock price will be less than the underlying business' value.* ***These*** *are the attractive buying opportunities for the rational and patient investor.*

Over the longer term, however, a company's stock price *will* reflect the value of the business. We do not think that anyone can consistently forecast (guess?) what stock prices will be in the short term but we *do* believe that it is possible to gain an understanding of a business' direction over the medium- to longer-term. This is how we spend the vast majority of our hours at Silver Heights: assessing the strengths, weaknesses, and likely outcomes of various business models.

From our perspective, the biggest risk we face is not that the stock price is volatile in the short term, but rather that a business' longer-term future does not unfold as we expect, and hence, our valuation of that business will be incorrect. While it is impossible to completely eliminate the risk of future uncertainties for a business, a rational and rigorous examination of a business can *substantially* reduce this risk. It's not surprising that so many investment managers choose not to undertake this type of disciplined analysis. Why go through all the effort if you are only intending to hold a stock for a few months?

How does all this relate to my investment returns?

What this all boils down to is having a proper perspective for the returns you are getting from your investment portfolio – whether you manage it yourself or it's managed by someone you've hired.

At Silver Heights, we think about investing with a long time horizon. With this mental framework and proper asset allocation, we can avoid the negative impact of short-term volatility. And, we take a simple, common-sense view of risk: "What is the chance that we could lose money?". Whatever your time frame and however you define risk, never look at your returns in isolation, without some thought given to risk levels. Here is a very simple example to illustrate this point. As is often the case, an extreme "for instance" may bring home the argument in a way that a more subtle example would not. Let's compare three hypothetical "offers":

(a) $1,000 to walk blindfolded across your driveway at midnight

(b) $10,000 to walk blindfolded across your residential street at midnight

(c) $100,000 to walk blindfolded across Highway 401 in Toronto at midnight

We doubt that any rational individual would automatically choose Option (c) simply because the "return" is potentially the highest. Unfortunately, the investment world is littered with such "offers": "*Come invest with us because our fund returned X% last year*". This type of advertising only tells the investor half of what they need to know to assess the merits of an investment. Choosing a fund solely on the return, without proper thought given to *how* those returns were achieved is analogous to choosing Option (c) in our example solely on the basis of the $100,000 being more than the $1,000 in Option (a).

Despite all the time and energy that has been devoted to the academic study of risk, it really comes down to common sense. It is a pity that such a relatively simple and intuitive concept (although not easily quantified) has been so muddied in the minds of today's investors.

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