The Perspective

Rational, independent thinking™

The Most Dangerous Thoughts

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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
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The Most Dangerous Thoughts

Risk. Virtually everything we do as investment managers revolves around risk. The one constant about risk is that it is always there in every investment we make. No investment is completely devoid of risk in one form or another.

Here is one of the most astute observations on risk we have ever seen.

> *"The tricky thing about risk is that it is more threatening as it seems less obvious and less threatening as it appears more obvious."*
>
> James Grant
> Publisher of "The Interest Rate Observer"

We live in harried times and if there's one comment we hear from virtually everybody, it's that "there aren't enough hours in the day". Because of these never-ending time pressures, it's human nature to want to simplify things with shortcuts.

As it is with other areas of our lives, there are "rules of thumb" in the investing world that are used – by both amateurs and professionals – to simplify risk assessment and decision making. We would caution against taking things *too* far, as a few of these nuggets of common wisdom may not be so wise. Substituting simplicity for correctness is dangerous thinking, especially when it comes to risk.

The most adverse outcomes often come from seemingly harmless actions and thoughts. Let's take a look at a few examples of "dangerous thoughts" that are often taken as truth but perhaps may not be as factual and harmless as their proponents would have you believe:

- you can't lose money owning your home
- you should always have some bonds in your portfolio for safety
- you have to take more risk to get higher returns

"You can't lose money owning your home"

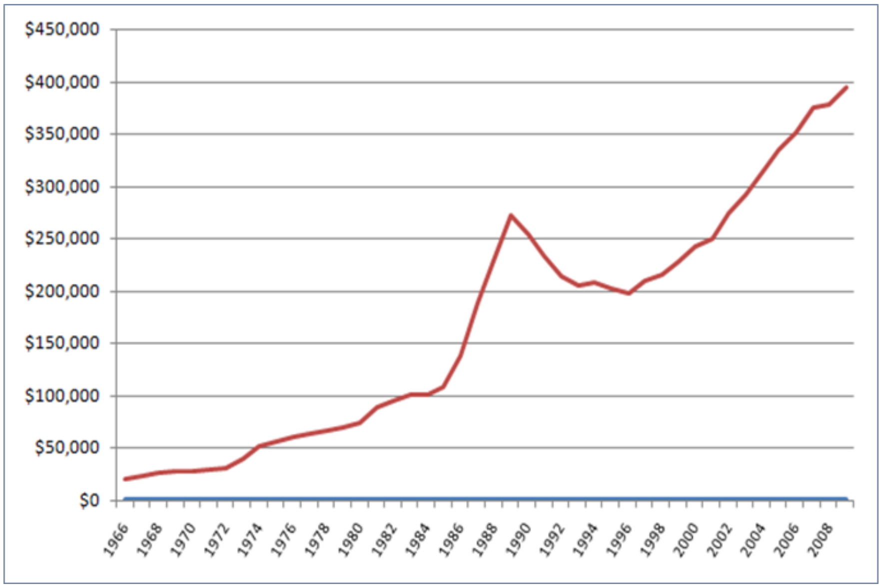
Before we begin discussing this point, we would like to be clear that we believe that there are very substantial benefits to owning one's home. Owning a home:

- can provide a tremendous sense of emotional comfort and pride for the owner;
- will result in a tax-free gain if sold for more than the purchase price; and
- can be an effective forced-savings plan for many people who would otherwise not have had the discipline to invest their money elsewhere.

Our objection to this idea refers ***only*** to the *investment* aspect of home ownership. That is, there are many people that think that they cannot lose money when buying a home and that real estate prices always go up. We suspect that the recent housing crisis in the U.S. has changed a few minds regarding this point but we are always surprised to see how many home buyers/owners don't think that the value of their house can go down, and certainly not substantially.

Closer to home, here is a chart showing house prices for the city of Toronto.

Average Price of a Single-family Home in Toronto



Source: Toronto Real Estate Board

For those that were fortunate enough to have invested in Toronto residential real estate in the mid-1990's, it certainly wouldn't be hard to find consensus regarding the positive aspects of real estate investing.

If you had purchased in 1989, however, you would likely have a different opinion. It would take until 2002 – *13 years later* – before prices recovered to where you started. In the interim, you would have endured a nearly 30% drop in prices (bottoming out in 1996). For many people, buying their home is the single-largest financial transaction and investment they will ever make. Imagine being in a significant loss position on your biggest investment seven years after the purchase. We would characterize ourselves as extremely patient investors, but taking over a decade to get back to zero is not our idea of investing fun.

The widespread use of financial leverage further increases the investment risk of home ownership. While leverage is understandable, as most people could not purchase a home without the use of debt, borrowing money does magnify the downside risk.

One of the partners at Silver Heights bought his first home for about $88,000. As a first-time homebuyer, he used $4,400 of his own money, or 5% of the purchase price, and borrowed the other 95%. When he sold the house three years later for $112,000, even after commissions, he made $20,000 on his $4,400 investment.

While at the time, he patted himself on the back for his astute investing, he had levered his money in a way that he would never have done to invest in any other asset. People would think we were crazy if we suggested that they borrow 19 times their money and invest the whole amount in one stock. Yet, many of these same people do exactly the same thing when it comes to their home.

Outside of the short-term and relatively minor reduction in prices in 2008 and 2009, housing prices in many of Canada's major cities have enjoyed a virtually-uninterrupted ascent for decades. Combine this long trend with today's low interest rates and you have the conditions that breed the complacency that can lead to financial fiascos.

While we are not saying that home prices *will* go down significantly, it is important to recognize that they *can*. Believing otherwise is the same sort of dangerous thinking that mesmerized homebuyers in Phoenix and other U.S. cities in 2006 and 2007.

"You should always have some bonds in your portfolio for safety"

Bonds have – for nearly three decades – been a good spot to preserve capital. Because of this, it has been ingrained into the minds of millions of investors that bonds and safety are synonymous.

When a strategy has worked so well for so long, it becomes taken as truth. How could it not be?

At the risk of insulting some readers, it is important to highlight that bonds do well in a declining interest environment, and poorly when rates rise. Even though a bond may make all its interest payments, its value will decline as interest rates rise. For example, a $1,000 bond with 10 years to maturity and a 4% coupon will be worth about $850 if rates rise to 6%. If rates were to increase to 8%, this bond would lose nearly 30% of its value and be worth only $730. This is a loss of value we suspect many bond investors would not have considered a possibility.

Here is an illustration of historical interest rates, using the 10-year U.S. Treasury as our proxy:

Yields on the 10-Year U.S. Treasury Note

Source: Yahoo! Finance

Bonds have had a *multi-decade tailwind* of declining rates. We have no idea where interest rates will be later this year, or next. But, we would hazard a guess that three, or four, or five years from now, there's a pretty good chance that rates will be higher than they are today. The impact on longer-term bonds will not be pretty. We are certainly not perfect, but when we make any investment, we make a concerted effort to understand and consciously acknowledge the risks present. For many bondholders, though, we think that the extended, positive run that they have had has resulted in blinders being raised to the risk of capital loss.

If Jim Grant is right in his observation on risk, then long-term bonds are one of the most dangerous investments because the notion that "bonds = safety" is so widely taken as gospel. But, don't take our word for it. There is perhaps no greater authority on bonds than Bill Gross, the legendary fixed-income investor who founded PIMCO, an asset management firm with over $1 trillion of assets under management. He recently stated:

> *"Bonds have had their best days. Real interest rates are moving higher. That's the main bear element in the bond market."*
>
> Bill Gross
> Founder, PIMCO

Despite these warnings, we think that many bond investors will still be blindsided when interest rates move up and their bond holdings suffer capital losses.

The risk in bonds has potentially enormous implications because they are so widely held by so many investors. In particular, many of the world's largest pools of capital have huge exposure to long-term bonds. Unlike many individual investors, more sophisticated institutional investors understand and acknowledge the risks that rising rates present to their bond holdings. However, we are surprised that even after this acknowledgement, their response to the risk they face seems relatively marginal. We've heard things along the lines of, "We believe there may be a significant risk of rising rates so we are reducing the bond weighting in our portfolio from 50% to 40%". At Silver Heights, we would be more inclined to avoid an unfavourable risk-to-reward scenario like this entirely.

For both real estate and bonds, the maxims highlighted above came to life because of the long-term trends experienced by investors in these assets. Well-respected business writer, Derek Decloet, summed up these risks well in a recent article on real estate:

> *"A funny thing happens to people when an economic or financial trend holds in place for a very long time. They begin to assume that 'a long time' equals 'forever'. You can see this clearly in the U.S. Its home prices hadn't declined on a national level since the Great Depression, so buyers and rating agencies assumed they could never go down – until they did."*
>
> Derek Decloet
> Business Reporter, The Globe and Mail

"You have to take more risk to get higher returns"

This is our favourite one. This notion is underpinned by the "Efficient Market Hypothesis". Without wanting to get too academic, the theory states that stock markets as a whole are very good at factoring in all the available information. As a result, it is fruitless to spend any effort trying to unearth undiscovered and undervalued investments and the only way to increase one's returns is to take on more risk.

It is amazing to us how many investors take this as truth. The dramatic rise in the popularity of index investing speaks to the pervasiveness of this thinking.

What is often omitted in discussions about the Efficient Market Hypothesis is that one of the fundamental premises of the theory is that market participants always act rationally. Clearly, we do not believe that this is what happens in real life. Silver Heights' slogan, "*Rational, independent thinking*", was carefully chosen and reflected our observations of the many irrational and self-defeating actions that many investors take.

What are the implications of the Efficient Market Hypothesis being wrong? In a nutshell, investors should be able to achieve higher returns while taking on less risk. Before you begin rolling your eyes, please hear us out. It may not be as crazy as it sounds.

Value investing is often summed up as "buying a dollar for less than a dollar". What happens if you bought this dollar for 75 cents and eventually sold it for its fair value of $1? You'd make 25 cents on a 75 cent investment for a return of 33%. Not bad. Now, imagine the results if you had the chance to buy that same dollar for 50 cents. In this case, when you sold it for its fair value of $1, you would make 50 cents on a 50 cent investment for a 100% return. Clearly, that return is a lot better than in the first scenario. But, equally important is the answer to the question, "Which investment was less risky?" It was the second one because you had less capital at risk, only 50 cents versus 75 cents.

> *The less you pay for an asset relative to its true economic value, the better the return you are likely to make and the less risk of capital loss you face.*

The million dollar question that goes the heart of the Efficient Market Hypothesis is, "Do markets misprice stocks?" And if so, do they misprice stocks to a meaningful degree? We would point to economic bubbles ranging from tulip mania in the 1600's to the recent housing bubble in the U.S. as clear examples of materially-mispriced assets.

In today's markets, there has been a dramatic rise in the volatility of stock prices. It's easy to find stocks whose 52-week high is four or five (or more) times its 52-week low. Ask any business owner and they will tell you that a business' true economic value is not nearly as volatile as stock price movements.

> *Because of the volatility in prices driven by human emotions, there **will** be times when stock prices will deviate **significantly** from the underlying business' economic, or intrinsic value. Sometimes the price will be much higher than intrinsic and sometimes, much lower. The key is to have a reasonable estimate of this value so that you can use price volatility to your advantage.*

In our last edition of *The Perspective*, "The Best Returns – part II", we showed a chart highlighting the importance of minimizing losses because of the significant gains subsequently required just to get back to break even. Here is that same chart, "Math behind Losses", but alongside a new chart we call the "Math behind Value Investing". The new chart quantifies what we stated earlier: **the less you pay for an asset relative to its intrinsic value, the more money you will make**. At the same time, by putting less money at risk, the potential for wealth-destroying large losses is significantly reduced.

Math behind Losses

Loss	Required return to break even
-10%	11%
-20%	25%
-30%	43%
-40%	67%
-50%	100%
-60%	150%
-70%	233%
-80%	400%
-90%	900%

Lower your risk, *and* → get higher returns

Math behind Value Investing

Price paid (as a percent of intrinsic value)	Return, if eventually sold for intrinsic value
100%	0%
90%	11%
80%	25%
70%	43%
60%	67%
50%	100%
40%	150%
30%	233%
20%	400%

Is it our imagination, or is there a striking similarity between the two tables? **Can taking less risk (i.e., paying less) result in higher returns?** The lower portions of each chart are clearly not common occurrences, but they *do* happen. Just ask the many investors who lost half, or more, of their money in 2008. Subsequently, in early 2009, there *were* companies that traded at mere fractions of their economic value, thus providing investors with the opportunity to make substantial returns with less risk.

The next time you are tempted to engage in dangerous thinking by accepting a "well-known" notion that certain investments are virtually without risk, we would caution you to recall James Grant's idea that risk is "more threatening as it seems less obvious".

At Silver Heights, we strive to take into account all the relevant risks, both more and less obvious, in our investment decision making. Please give us a call if you would like to hear more about how our rational, independent thinking can work for you.

Sincerely,

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