

Quiet Counsel

Summer 2017
Investment Outlook



Leith Wheeler
INVESTMENT COUNSEL LTD.

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Picking Stocks: Lessons Learned Over The Past 30 Plus Years

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I was recently reflecting on the many lessons I have learned over my career as an equity analyst at Leith Wheeler. I thought I would describe the following four lessons as well as some of the mistakes I have made over the years.

Lesson 1: The stock market is a para-mutual betting system.

This is how Bill Wheeler, one of the co-founders of Leith Wheeler, described his investment philosophy to me. The concept is that when betting on a horse-race, it is not enough to correctly pick the winner of the race (although this is, obviously, important). Ideally, one should pick a horse that ends up doing better than it was expected to do. Often, the winner of a race is the favourite coming into the race. Because of the nature of the para-mutual betting system (odds constantly change based on new wagering information), the favourite horse is by definition expected to do well, a lot of money is typically wagered on it and this combination often results in a relatively poor payoff. If the

favourite does indeed win the race, the payoff on this bet is quite small, and if the favourite doesn't win the race, the payoff is typically tiny or zero. On the other hand, if one has some insight that a relatively unpopular horse has the potential to do well, the payoff can be quite attractive. The unpopular horse may not win, but a bet on it can pay off quite handsomely even if it only "places" or "shows". Bill Wheeler would often attend investment conferences that featured several company presentations taking place at



the same time in different rooms. He would decide which company presentation to attend by looking into the rooms and choosing the room that had the poorest attendance. His lesson was to invest in companies in which investor expectations were low!

Lesson 2: Never invest on the basis of a story on Page One...invest on the basis of a story on Page Sixteen that's on its way to Page One.

I am paraphrasing a quote by Don Coxe, who was BMO's strategist for many years, which I have always found to be very insightful. The security markets are populated by millions of bright people, each hoping to make money. Money-making ideas are scarce and material new information becomes imbedded in security prices very quickly. By the time an issue hits the front page of a major newspaper, the security markets have almost certainly priced the issue in an efficient manner. For example, if a new toy becomes so popular that it becomes featured on the front page of a major newspaper, invariably the valuation of the company producing the toy will have already been bid up significantly. The lesson learned is that a "page one" story typically does not provide insight that has not already been imbedded in security prices.



Perhaps there is a very positive review of a new toy on page sixteen of the newspaper. Many readers may only take a passing interest in the story. An astute observer may use this article to begin further research into the company that produces the toy and find that the toy's profit potential is large yet the valuation of the toy company has not yet reacted meaningfully to the introduction of the new product.

We may be witnessing another example of this lesson today with the price of oil and the valuation of energy

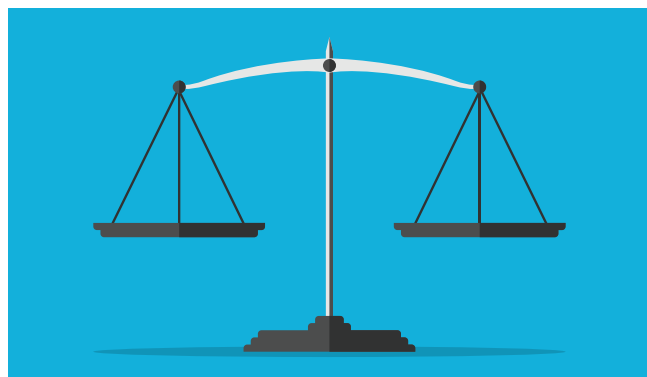
companies. The current page one story outlines how oversupplied the world is in oil, how the U.S. shale revolution is a phenomenon that is here to stay and how a number of energy companies are struggling financially. Not surprisingly, energy stocks have been underperforming the broad stock market for some time and their valuations are well off of their highs. Perhaps one should start to look for Page 16 stories that outline how a number of oil producers have started to cut back production, aggressively reduce costs and renegotiate lending agreements. The seeds of a recovery may be getting sown, but these seeds are usually not seen on Page 1!

Lesson 3: In the short-run, the market is a voting machine but in the long run, it is a weighing machine.

This is a famous quote of Benjamin Grahams' in his book "Security Analysis" which was first published in 1934. It is truly a brilliant insight and I reflect upon it regularly.

I often hear stock market participants saying "the price action of stock X is telling us that the company is in deep distress and should be avoided". The price action, or recent trading pattern of a specific stock may be telling investors something useful or it may not be. A stock's short-term price action is simply a reflection of the investment community's current consensus view of the prospects of the company ("the voting machine"). This consensus view can change very quickly!

I believe Benjamin Graham was trying to make the point that investment returns over longer periods of time are largely a result of the relative attractiveness and durability of a company's business model; the future increase in the company's revenues, earnings and free cash flow will ultimately have a large impact on an investor's returns from owning that investment ("the weighing machine").



So buy strong businesses, but be patient as they will become available at attractive valuations from time to time.

Lesson 4: It's OK to say "I don't know."

I have found that investors commonly search for answers to questions that are very difficult or nearly impossible to answer with any degree of confidence. The "noise" in our society is overwhelming and bombards us daily. It is often very difficult to differentiate an insightful piece of information from yet another relatively useless piece of information, or "noise". I have learned that it is very important to think about the quality of the source of the information that one gets and whether that source has an "axe to grind". A good economist may well have some insightful data on the relative competitiveness of one country versus another. However, in an interview, this economist may be asked for his opinion on the stock market. Not only is this a very difficult question to provide insight into, but it is unlikely that the economist will have meaningful expertise on this subject.

I remember attending the 50th anniversary of Berkshire Hathaway's annual meeting in 2015. The oil price had fallen from \$110 per barrel to \$50 per barrel over the

previous year and a shareholder asked Charlie Munger, the Chair of Berkshire Hathaway, for his prediction on the price of oil over the next year. I remember Charlie's answer and finding it refreshingly honest. To paraphrase, he said, "I didn't anticipate the drop in the price of oil from \$110 to \$50, so why would you be interested in my prediction on the price of oil in the future?"

The lesson I took away from that exchange was that a successful investor is intellectually honest, recognizes when they do not have an insight into an investment issue, and is willing to patiently wait for a future investment opportunity where they do possess some insight.



Mistakes

To wrap up, I wanted to review some common stock-picking mistakes, all of which I have made:

Misjudging the quality of the management team of a company.

All CEO's will confidently outline the rosy future prospects of their company, but frequently actual results fall well short of rosy projections. It is important to review the past performance of management teams and focus one's investments on those teams that have demonstrated past success. Believing that "leopards can change their spots" has not worked out well for me. In the energy sector, I have observed that it is particularly critical to invest in management teams that have a history of success.

Weak business models can break.

If a company truly has a strong business model, it should be able to demonstrate a relatively high return on capital invested, a growing earnings stream over time and the

generation of free cash flow. If it can't generate these three things, I would recommend looking elsewhere. One of the reasons Leith Wheeler was able to avoid the implosion that occurred with the stock Valeant Pharmaceuticals is because it failed to display any of these attributes as it rode a wave of popularity from 2008 – 2015, so we never owned it.

Excessive debt can force a company to become distressed before one's investment thesis has had time to play out. Err on the side of stronger balance sheets; a strong balance sheet gives a company many more strategic options when industry conditions turn down, as they inevitably will. Teck Resources is a recent example of a cyclical business that had a levered balance sheet when metallurgical coal prices plummeted in 2015. The company survived the downturn and subsequently recovered after taking steps to address its balance sheet, but its leverage was a factor in the extreme volatility of the stock over the 2014 - 2016 period.

Ask yourself, “where is the cloud over this investment?”

If there is no cloud or issue that the investment community is currently concerned about, chances are that the company's stock is richly valued and prospective returns may well be relatively limited. Some of the technology darlings of today may well fall into this category.

Being involved in the equity markets for over 30 years has been a fascinating, and at times, humbling experience. I am grateful to work with so many talented individuals and to work in a firm that values independent investment research and security selection so highly.

Author's Note:

Bill Dye joined Leith Wheeler in May 1985 and has held positions including Executive Vice President, Chief Investment Officer and is currently Head of Canadian Equities. He has seen the firm grow from \$130 million of assets under management to its current level of \$18 billion.

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