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STRATEGIES FOR SUCCESSFUL INVESTING

MARKET WISDOM

Build a diversified portfolio with a disciplined strategy where...

QUALITY MATTERS

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THE S&P/TSX COMPOSITE INDEX, including reinvested dividends, recently turned positive compared to the market's peak prior to the onset of the financial crisis in 2008.

To illustrate the extreme volatility the market has experienced, consider this: if an investor would have missed even a few of the best days of market performance, those returns would remain in negative territory.

The question is, what investment style should a conscientious investor adhere to in order to balance risk and return? How can an investor benefit from equity market growth and still be able to sleep soundly at night?

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Warren Buffett famously joked, "[w]hether we're talking about socks or stocks, I like buying quality merchandise when it is marked down." It is this philosophy of quality investing that helps us avoid value traps on one extreme and growth disappointments on the other.

In my opinion, investing in a well-diversified portfolio of high-quality stocks trading at reasonable valuations should provide steady and consistent results over the course of an investment cycle.

So what is my high-quality investment philosophy? Own companies with defendable competitive advantages, prudent financial leverage and strong management teams that are trading at a discount to long term intrinsic value.

A competitive advantage can lead to better returns than a company's peer group, while a conservative balance sheet leads to optionality and flexibility during times of opportunity or crisis.

Additionally, a strong management team, as demonstrated through characteristics such as consistency, experience and forthrightness, is an essential factor when identifying quality companies.

A company like this can be held through the ups and downs of market volatility, limiting unnecessary transaction costs.

In Jim Collin's book, *Good to Great*, he shows empirical evidence that companies with a long track record of outstanding performance can continue to outperform the market, supporting the notion that high-quality companies rarely fall out of favour.

A quality-focused strategy attempts to highlight companies in leadership positions with strong free cash flow, which can ultimately lead to growing dividends and positive returns for shareholders.

MAKING THE GRADE

Below are three companies in three very different sectors that meet my quality criteria.

These companies have strong competitive advantages, prudent financial management and strong management teams. What's more, all of the stocks currently trade at an attractive relative valuation.

Canadian National Railway Co. is a company that meets my quality requirements and trades at a substantial discount to its long-term fundamental value.

CNR's main competitive

advantage is its 21,100 route-miles of track connecting three coasts: the Atlantic, the Pacific and the Gulf of Mexico. The railway's financial pulse is driven by the North American economy, which (at the moment) is showing signs of significant improvement.

Compared with its peers, CNR has consistently maintained a higher return on equity along with a lower operating ratio. (A low operating ratio for the railroad industry is positive because it compares operating expenses to revenue and demonstrates the efficiency of a company's operations.)

High-quality companies rarely fall out of favour

Canadian National Railway has increased its dividend ten times in the past decade, with a total return over three times greater than the S&P/TSX Composite Index during that period.

With assets in Alberta, **MEG Energy Corp.** is a heavy oil producer that I believe meets the quality criteria. Finding high-quality resource firms can be a challenge given the industry's poor history of value creation, but this company is expected to grow production by over 20 per cent each year for the next decade.

What sets MEG apart from other hyper-growth companies? Its low cost structure, and the series of contingency plans that management has put in place to ensure they successfully meet ambitious targets.

Inevitably, there will be external factors that impede the company's growth. But by anticipating problems and preparing solutions, management demonstrates a pro-active approach and a long-term focus.

For example, MEG Energy has all of its equity financing in place for the next leg of growth, but will not proceed with subsequent development stages unless funding is secure. This prudent approach limits its exposure to the unpredictable and fastidious moods of the market.

In another example of management's pro-active approach: their preplanning and foresight in gaining access to end markets for its heavy oil at the best possible price.

MEG does not rely solely on conventional pipelines to sell its crude; instead, the company diversifies by shipping barrels on rail and barge to access U.S. gulf coast customers.

MEG Energy will continue to be impacted by the short-term fluctuations in the Canadian oil price differential with the U.S.

Over the long-term, however, the high-quality nature of this company and its well-planned road map for growth should ultimately reward patient investors.

Intact Financial Corp. is another high-quality company that uses its scale and dominant market position to its competitive advantage. Intact is the largest property and casualty insurer in Canada, operating through popular brands such as Grey Power and Belairdirect.

The company has been able to use economies of scale and a more sophisticated database of statistical records to significantly outperform the industry on metrics such as return on equity and premium growth. Operating in a fragmented industry, the quality of Intact's management team has been demonstrated by their disciplined approach to acquisitions.

The company only acquires smaller competitors that have deep expertise in a specific line of business, prudently requiring a 15 per cent internal rate of return before moving forward with an acquisition.

The insurer has also increased the dividend every year since 2005, with a total shareholder return more than double the S&P/TSX Composite Index since the company's listing.

BUILT TO OUTPERFORM

Certain investment strategies are more effective during different market conditions. I believe that a disciplined strategy focused on building a diversified portfolio of high-quality companies has the opportunity to outperform in most market environments.

Quality companies, as defined by defendable competitive advantages, a conservative balance sheet, and a strong management team, generate high returns on equity, grow free cash flow, and ultimately increase returns for investors through higher dividends and capital appreciation. Quality does matter! ▼

Three high-quality stocks – at a glance

	Price	Dividend	Yield
Canadian Nat.'l Railway (TSX-CNR)	$105.54	$1.72	1.63%
MEG Energy Corp (TSX-MEG)	$35.59	-	-
Intact Financial Corp. (TSX-IFC)	$62.62	$1.76	2.81%