

THE MONEYLETTER[®]

STRATEGIES FOR SUCCESSFUL INVESTING

VALUE INVESTOR

Don't listen to the temptations of Mr. Market, keep your eyes out for...

HIDDEN VALUE

Colum McKinley, CFA

VALUE INVESTING WORKS. OVER the long term, it has consistently outperformed the market as a whole.

This strategy advocates selecting a stock that trades for less than its intrinsic value – that is, its actual value compared to its market price.

Value investors believe that the market overreacts to good and bad news, rather than to facts and analysis. This results in stock price movements that do not correspond to a company's long-term fundamentals.

This in turn gives investors an opportunity to profit by buying

when the price is deflated, or undervalued.

Benjamin Graham, considered the father of value investing, began teaching his approach at Columbia Business School in 1928. He also published his thoughts in two highly influential books, *Security Analysis* and *The Intelligent Investor*.

In *The Intelligent Investor*, Dr. Graham created the metaphor of Mr. Market. This character is an imaginary investor who represents the market and turns up at the stockholder's door every day offering to buy or sell his shares at a different price.

The investor is free to trade with him, or to ignore him completely. Dr. Market doesn't mind it either way. Like clockwork, he will be back the following day to give the stockholder another price.

The allegory of Mr. Market with his daily temptations to trade serves to explain why stock prices tend to fluctuate – and why it is usually best to ignore these fluctuations. It is far more beneficial to focus on the long-term valuation, or intrinsic value, of a company as determined through fundamental analysis.

I recently joined CIBC Global Asset Management as the manager of the value portfolios and my role as lead portfolio manager for the **Renaissance Core Value Fund** and the **CIBC Equity Value Fund** is to take advantage of the pricing discrepancies that Mr. Market creates.

In order to shed some light on these issues, I decided to hold a conversation with the metaphorical Mr. Market. I invited him to visit us at CIBC Global Asset Management to ask some questions about today's market.

Our discussion was a reminder of just how important it is to be a long-term investor focused on buying solid businesses with low valuations and high dividend yields. It went something like this.

Markets today seem more volatile than ever. It seems that prices are set too high one day and then too low the next. Your thoughts?

Volatility is not always a bad thing. A temporary decline in a stock price is exactly the type of opportunity that allows me to



Colum McKinley, CFA is vice president of Canadian equities at CIBC Global Asset Management and is the manager of the CIBC Canadian Equity Value Fund and the Renaissance Canadian Core Value Fund.

colum.mckinley@cibc.ca

reposition our funds for future growth. Volatility allows us to take capital from the best-performing stocks in the portfolio and reallocate it to those stocks that are temporarily mispriced.

By following a very disciplined investment process we can identify opportunities and take advantage of market volatility.

We use a proprietary intrinsic value model which provides a rough estimate of the fair value of a business using three key inputs – price-to-earnings ratio, book value, and return on equity – to screen all the S&P/TSX stocks and identify those that are undervalued. We review the most appealing stocks that make it through the screen using further in depth fundamental analysis – examining the company's accounting, corporate governance and strategy. From this even more concentrated group we identify the best opportunities.

In practice, our portfolios are made up of large, stable, blue-chip companies trading at attractive prices. These are businesses that have already proven their ability to weather economic uncertainty.

By consistently preserving capital in weak or declining markets and providing attractive returns in rising markets, portfolios armed with these stocks should bring above-average returns with lower volatility over the long-term.

BCE INC.

Take **BCE Inc.** (TSX-BCE, \$32.46), Canada's largest telecom stock, as an example. The company's stock price has fallen over the last several years in the wake of its failed privatiza-

tion bid and the threat of competition from new wireless competitors.

In response, BCE's management has aggressively cut costs and increased its focus on customer service.

We are already seeing early signs of the strategy working. We expect BCE's cash flow to remain strong and to benefit from increased consumer and corporate spending.

In the last two years, BCE has increased its dividend by 19 per cent, from \$1.46 to \$1.74 per share.

We also expect future dividend increases as a result of the company's strong free cash flow and the stated desire of its board to return capital to shareholders. The stock is trading at 11 times next year's expected earnings and its dividend currently yields 5.4 per cent.

These changes at BCE remind me of the evolution of CN Railway. Like BCE, CN changed from being a big fat bureaucratic organization into a lean industry leader.

By cutting costs and focusing on exceeding customer expectations, CN was able to improve its profitability and cash flow dramatically. Its management was able to invest in the business and still return capital to shareholders.

Isn't the Canadian stock market too concentrated in the materials, energy, and financials sectors? Don't value investors stay away from the unpredictable nature of commodity companies?

We see the world from the perspective of bottom-up stock pickers. Our portfolios are con-

structed with an emphasis on managing risk and protecting against the downside of the market, as well as avoiding unintended risks.

Our fund's sector allocation does not usually deviate by more than five per cent from sector weights you find in the S&P/TSX.

The decision reflects the idiosyncrasies of the Canadian market and its high concentration in certain sectors. Again, we add value through stock selection, taking advantage of the pricing discrepancies created by the market.

It can never be repeated too often – buying great Canadian businesses that offer superior fundamentals and steady dividends when they are temporarily mispriced is the best possible means to deliver consistent, long-term results.

SUNCOR ENERGY

The recent volatility in the stock price of **Suncor Energy** (TSX-SU, \$34.48) has enabled us to add to one of the best integrated operators in the energy sector.

The company is in the process of absorbing the Petro-Canada acquisition and, as with many large acquisitions, there have been short-term challenges.

In addition, Suncor recently experienced a fire at one of its oil sands upgraders which detracted from quarterly production levels. However, this has a minimal effect on the long-term value of Suncor's assets. Suncor has remaining recoverable resources of 27 billion barrels of oil and a reserve life index in excess of 60 years.

These assets represent a highly predictable and stable source of future production and, ultimately, cash flow. At today's prices, Sun-cor is an excellent high-quality stock with which to gain exposure to the energy sector.

We hear about China's slowing growth, credit problems in Europe, and the risk of a double dip recession. Does that mean it's time to sell and wait for better market conditions?

Even as bottom-up stock pickers we view these events as potentially very significant. By understanding economic trends, we can shape our portfolios to deliver future performance.

Under all conditions we are continuously vigilant about monitoring possible risks on the horizon.

CIBC Global Asset Management has strength and expertise across all asset classes, including fixed income, foreign exchange, and global equities. This provides me with a strong perspective on how global trends will affect corporate profitability and future asset class returns.

Accordingly, we can position our investments to take advantage of these trends as they unfold.

We continue to hold the view that while the rate of GDP growth is abating, real growth in the world will still average around 3.8 per cent over the next twelve months.

This is likely an environment in which the economy will occasionally take two steps forward and one step back – exactly the kind of environment that

favours large, well-capitalized businesses boasting strong fundamentals.

These are the stocks that will not only survive, but also thrive when they come through the credit crisis.

Historically, the Canadian stock market has been a consistent generator of returns for long-term investors. Over the last 50 years, the Canadian stock market has never experienced a rolling 10-year period of negative returns.

TECK RESOURCES

As the market became concerned with the risks of a slowing global economy, many material stocks declined in price.

Some fell too much. **Teck Resources** (TSX-TCK.B, \$36.11) is a good example. It fell from a high of \$46.03 to a low of \$30.27.

Currently, the price stands at a meaningful discount to its net asset value. This reflects coking coal prices at around \$115 a tonne, below the industry's marginal cost of production of about \$125 a tonne.

This is in stark contrast to current spot prices, which are in excess of \$200 a tonne.

In addition, Teck's recent reinstatement of its dividend shows a desire to return future excess capital to shareholders. We expect the dividend to grow over time.

We also expect the company's operating cash flow to rise from \$3.2 billion in 2009 to \$4.6 billion in 2012, providing ample

opportunity to reduce its debt and increase dividends.

Teck offers the combination of a growing dividend, with its significant margin of safety, and the potential for strong capital appreciation.

Benjamin Graham's Mr. Market teaches us important lessons about value investing and the effects of investor psychology.

His fixation on today's prices reflects either enthusiasm or pessimism based on his changing thoughts on recent economic, social, or business news.

Don't follow Mr. Market or his thought process. Investors always do best when they have the ability to avoid the daily turmoil of investor psychology and look beyond short-term challenges.

Buying good-quality businesses at attractive prices with strong dividend yields is the best way to consistently produce wealth over the long-term.

In fact, I'm sure that Mr. Market left our offices a sadder but wiser man. ▼

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