The Quarterly Opportunity Update – 3rd Quarter 2021

Recorded and produced on Monday October 4th, 2021 – data and pricing references are as at September 30, 2021 unless otherwise stated.

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Track #1: Introduction – The Skinny

Hi, this is Chris Raper, Senior Wealth Advisor & Senior Portfolio Manager, Private Client Group of Raymond James Ltd. & co-founder of **The Dividend Value Discipline™**. Welcome to what will be now known as **The Q3 Opportunity Update**, which today and on a go forward basis is the amalgamation of what used to be **The Opportunity Update** and **The Quarterly Market Commentary**. This recording comes to you from Victoria B.C. on Monday, Oct 4th, 2021.

This recording is accompanied with a transcript complete with charts which provide evidence to the issues I will be speaking on – you will probably get more out of audio by referencing the transcript.

- You are listening to **Track # 1: The Skinny**, where I am going to give you the high points on what we are going to cover today.
- On **Track # 2: The Big Picture**, we'll cover our macro view of the world, updating you on our leading economic indicators, interest rates, currencies and key commodity prices, investor sentiment, all of which have an impact on stock prices. As you can appreciate, the capital markets are a complex system that are in constant flux - that's why stock prices defy straight line extrapolation. That said, trends tend to last far longer than one can imagine and if you have been following our work, you will know that our June 4, 2021 recording we led with Canada's Next Supercycle Is Now Underway, a theme that I still have deep conviction for.
- On **Track # 3: The Dividend Value Discipline™ - Pool Corporation** – we will highlight one of our recent acquisitions in our core program and in doing so demonstrate a good part of our investment philosophy and process.
- On **Track # 4: The Complement Strategies**, we will cover brief commentaries on our in-house ancillary investment strategies that round out specific client needs. They are:
    - **The Tax Advantaged Preferred Share (TAPS) Strategy**
    - **The Keep More Income (KMI) Strategy**
    - **The Global Active Macro ETF (GAME) Strategy**
    - **The Next Cycle Resource Fund (NCRF)**

- **On Track #5: The Wrap Up – Buckle Up, It's October,** we will wrap it all up, give you the key takeaways and speak to the historically most volatile month of the year – read opportunity, not problem.
- On **Track #6: Postscript I – Our Approach** is for the benefit of prospective clients. It will give you some insight on the new client process that we walk interested parties through. Spoiler alert – it starts with you and your story - our approach is tailored to your "do, have, and legacy" ambitions. We need to understand your aspirations before we can help you achieve them.
- On **Track #7: Postscript II** is where I walk you through the methodology and return objectives of our core program, **The Dividend Value Discipline™**. If you have an interest in the specifics of our core investment process, you will probably get a lot out of it – if that's not you, you may want give it a pass.

In terms of legal requirements, there are three things to note:

1. The opinions that are expressed on this recording are mine. They may differ from those of Raymond James Ltd.

2. Raymond James Ltd. is a member of the Canadian Investor Protection Fund. That is a good thing. If you are interested in those details, please ask me or any one of our relationship managers the next time we speak.

3. The transcript of this recording provides links to other Internet sites for the convenience of users. Raymond James Ltd. is not responsible for the availability or content of these external sites, nor does Raymond James Ltd. endorse, warrant or guarantee the products, services or information described or offered at these other Internet sites. Users cannot assume that the external sites will abide by the same Privacy Policy which Raymond James Ltd. adheres to.

I also want you to recognize that some of the things I am going to say today are going to be proven wrong. It is an inevitable part of this business. It is also important to recognize that you don't have to be right all the time to do well. You just have to be more right than most or, conversely, less wrong than most.

Finally, regarding investment jargon, when I say I am bullish, it means I expect things to go up. When I say I am bearish, it means I expect things to go down. Likewise, north means up and south means down. When I speak about rent cheques, I am speaking about income, primarily dividends. You may hear me using the term “disruptor”, which is our moniker for those companies that are disrupting or re-inventing the way business is done in their particular market and are thereby able to grow at rates far faster than those of the economy. Think of Wal-Mart twenty years ago and Amazon today. You may also hear me use the term “aggregator”, which is our moniker for those companies that have a systemized approach to acquiring smaller competitors as a means to fuel their growth. That growth is the path to increasing dividends or in our language, growing rent cheques. If you catch me using industry jargon beyond that, I invite you to call me out. Send an email to the office and the team will let me know, usually with considerable gusto!

That’s a wrap on the skinny, and off we go to Track #2.

Track #2: The Markets – The Big Picture

The adjacent chart reflects the US Sector Returns to Sept. 30, 2021, the top three performing sectors on a YTD basis are energy, financial and real estate, primarily real estate trusts or REITs in industry parlance. As always, I caution you from straight line extrapolation – simply put, that is not how markets work. The more important question is what has recently changed that may change the course of the present-day trajectory.

US Sector Returns as of 30-Sep-21

Symbol	Sector fund name	2020	2021 YTD
XLE	Energy Sector Fund	-32.5%	42.0%
XLF	Financial Sector Fund	-1.7%	28.9%
XLRE	Real Estate Sector Fund	-2.1%	24.3%
XLC	Communication Services Sector Fund	26.9%	19.3%
XLK	Technology Sector Fund	43.6%	15.5%
XLV	Health Care Sector Fund	13.3%	13.4%
XLY	Consumer Discretionary Sector Fund	29.6%	12.1%
XLI	Industrial Sector Fund	11.0%	11.5%
XLB	Materials Sector Fund	20.5%	10.7%
XLU	Utilities Sector Fund	0.6%	4.2%
XLP	Consumer Staples Sector Fund	10.1%	3.9%

What follows are the most relevant developments, from our perspective of course ☺.

In terms of our leading indicators, our vector for the developing economies is the price of copper because copper goes into just about every manufactured good you can think of. Roughly speaking, copper is at the same level as it was at the end of Q2 and we see the upward trajectory from the Covid induced collapse as now in jeopardy. The energy blackouts in both China and Europe are obviously taking their toll.

Turning to the developed economies, our main vector there is the semi-conductor index and that's because most of our economy is made up of human ingenuity and thus processing power gets harnessed to drive our economies north. When we look at the chart from June 30 to September 30, we see that it is marginally lower, but still in an upward sloping trajectory. Undoubtedly, this has been impacted by the global supply crunch in semi-conductors. We can see that playing out before our eyes – car dealers in my circle report that they are holding less than 20% of what would be considered normal new vehicle inventory. Stories like this should give us pause because there is no way that such a headwind cannot impact corporate earnings to the downside.

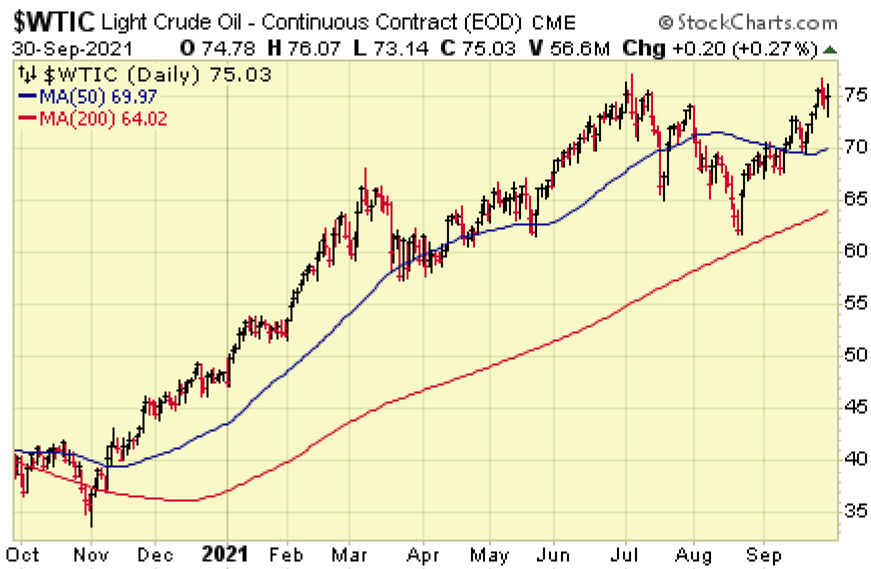
Interest rates are rising – the world's benchmark rate, the 10 Year US Treasury Yield broke out of its summer doldrums at roughly 1.40% and closed out the quarter at 1.55%. Simply put, higher rates generally push stock prices down because we buy stocks in anticipation of future earnings. As rates rise, investors ask themselves, if I can have a better bird in the hand today, are two birds in the bush worth waiting for?

Charts courtesy of StockCharts.com

Turning to the $USD Index, my comments from our last recording were just plain wrong. The reality is that $USD has rallied, not fallen, and now looks to be breaking to the upside. We may be witnessing a flight to safety given the most recent developments in China's property markets and or the improved attractiveness of the 10 Year US Treasuries means that you need to buy $USD's to buy them. As far as our $CAD goes, given our outlook for the energy complex, we see the loonie as undervalued and look for it to rally as we approach year end.

Charts courtesy of StockCharts.com

Without a doubt the biggest change we have seen since last quarter is in energy prices. Oil prices have been persistently high despite the summer spike in Covid and reduced air travel which lends credence to my belief we are in a global supply deficit. It should be noted that Canada's producers are seeing the highest prices in years due to improved egress. Oil prices are a Sunday school picnic compared to natural gas. Using the nearby CME Henry Hub futures as a proxy, it moved from $3.62 to $5.62 per thousand cubic feet, up a whopping 55% on the quarter. As many of you know, we have participated in that move through our ownership of Tourmaline, Arc Resources and some of our energy related Exchange Traded Funds (ETFs).



Charts courtesy of StockCharts.com

My suggestion to you is that the bold claim of [Canada's Next Supercycle Is Now Underway] in our June 4/21 recording is being played out. A note of caution is warranted for first time listeners - short term, I do see the natural gas complex as being overbought.

Putting it all together, I do see some headwinds for corporate earnings – they have to contend with far higher energy prices, higher interest rates, material supply shortages and an undeniable labour shortage. The latter will only be resolved through higher wages, which is the most permanent kind of inflation there is. No, I do not believe inflation is transitionary – for me it is a secular shift north. Obviously, the above will not affect all companies equally. Are we in for a catastrophic downturn? Not likely in my view – investor sentiment is extremely negative https://money.cnn.com/data/fear-and-greed/ and that is an indication that the much of the bad news is priced in – when we watch money flows it is readily apparent that cash is coming out of the super large companies of the world, i.e. Apple, Microsoft, Amazon, Alphabet & Facebook and that money is being reallocated into smaller capitalization stocks where investors are seeing more attractive value propositions. It argues for sector rotation as opposed to imminent collapse.

With that we are off to Track #3.

Track #3: The Dividend Value Discipline™- Pool Corporation

Before we get to Pool, I just want to give you an indication of where we landed performance wise for the year to date Sept 30/21 period. Most accounts in the balanced version (fixed income and equities) pegged at roughly 15% whereas the equities-only version was 19%. New entrants to the program will not have done that well because we buy only what becomes attractive on a go forward basis. In short, we want to protect your hard earned money. As you know, no two accounts are exactly alike due to different start dates and the timing of additional capital and withdrawals. Your individual returns can be found on your quarterly report which you will receive via your inbox and or in rare cases, snail mail.

Now let's take the deep dive into Pool, pun intended. I picked Pool because it is a relatively easy company to understand and it is a company that rates very highly across all our investment criteria. Embarrassingly, it is a company that we have followed for years and always thought it was too expensive, yet every year it surprised to the upside, and the stock price followed suit. After decades in this business, I am convinced that truly exceptional companies are always going to look expensive relative to their peers…and for the most part, should be bought.

Let's, start with what they do – primarily, they supply contractors, specialty retail stores and maintenance companies with new equipment and ongoing supplies for pools and spas. Roughly 86% of their sales comes from that source and they are leveraging their top notch distribution network to take advantage of everything in close proximity to that pool, notably irrigation and landscape supplies.

- Our sleuth analyst, Alex Vozian, was the first to identify Pool and job one at our shop is study the **corporate culture**. Pool has a very simple mission statement - *To provide **EXCEPTIONAL:** value to our customers & suppliers - return for our shareholders - opportunities for our employees.* That does amount to a hill of beans unless they can walk the talk. Here is some evidence that makes us believers - the executives own a lot of shares and almost 40% of their compensation is tied to long term returns. A signal that they have drank the Kool-Aid. The return on invested capital has grown from 20% in 2015 to 39% in 2020 – as a shareholder, I'd say that is pretty impressive. Employees appreciate the autonomy from their decentralized model. Every sale centre has its own profit and loss responsibility. Suppliers and customers appreciate their B2B web based portal, Pool 360^0 allows them to operate their business from their location and timing of choice. I could go on but I think you get the picture.

- The next thing we look at is **moat** and more importantly, is that moat getting wider, deeper and are they adding more crocodiles? In other words is their competitive advantage expanding or shrinking. The evidence in Pool's case clearly says expanding. They now have more than 400 distribution centres across North America, Australia and more recently Europe. Their scale and capital strength allows them to buy smaller competitors and bring them into the fold – a classic aggregator. Their enviable distribution network handles over 200,000 products from 2,200 suppliers. Their product training juices their organic growth. Bottom line - Pool is a really tough competitor and it is getting even tougher as they round out pool supplies with irrigation and landscape equipment.

- Next up is headwinds or tailwinds, and here the tailwinds seem to rule. The Covid-induced move to the country created a lot more pools and spas that now need to be maintained. Almost 60% of their revenue is maintenance and minor repair – our read is an expanding base of sticky customers. A lot of people who moved to the country are there to stay with the increased work flexibility now being afforded by many employers. Many of the Covid refugee's have young families. If that doesn't do boost sales perhaps last summer's heat will. Yes, there are the headwinds that every other company is facing, i.e. increased materials inflation, supply disruption and wage pressures. Our view is that the tailwinds will trump the headwinds.

- What about Environmental, Social and Governance (ESG) considerations? As most of you know, we take a pragmatic approach to ESG and are not willing to take the ratings agencies ESG scores at carte blanche. That said, **Investor's Business Daily®** ranked Pool Corporation as second among the **Best ESG Companies** in its **2020 IBD Composite Ratings**. Take a look under the hood and you will see a big focus on energy saving products like LED lighting, variable speed pumps, solar heating, right down to reusable cartridge filters. The company gets high marks for how they engage with both employees and suppliers and the governance largely gets looked after with our culture study.

- Finally, we get to the rent cheque (dividend) growth which ultimately gets fueled by growing free cash flow. The track record is one of strong double-digit growth in the company's quarterly dividend and the latest raise was a whopping 38%. No, we don't expect that next year but the rule of 72, says it is not unreasonable to expect the dividend to double in the next five years. It has tripled in the last 5 years. My standard analogy, if you owned an apartment block where the rents doubled every five years, what is the chance you would be inclined to sell at every hiccup in the real estate market? We should treat our great companies the same way.

That is a wrap for this track – I trust the Pool examples demonstrate our investment process for **The Dividend Value Discipline™**, which is by far our largest mandate we operate in terms of $'s managed and resources allocated to it.

We are off to track #4.

Track #4: The Complement Strategies

As I alluded to in the skinny, what follows are our in-house investment strategies that have been developed to meet specific client needs. Three out of the four of them were administered on an ad hoc basis say 12 months ago and thus 3 out of the four do not have a track record, return wise, that I can speak about publicly. It is an industry standard that I am more than happy to abide by. What I can say, is that we are well pleased with the progress we have made and in one case, I am relieved that I can't say anything because the returns have been so strong that I do not want people extrapolating that into the future.

For today, we will focus on why we each strategy was developed, the type of investor where there might be a fit and finally any macro notes to the investment environment specific to each mandate. So without further adieu we will kick things off with:

- **The Tax Advantaged Preferred Share (TAPS) Strategy** – or TAPS for short. We developed the TAPS program last fall because I was tired of the inefficiencies with buying tax-advantaged Canadian preferred shares for clients on a non discretionary business and I have strong dislike for commissions. It just opposes my "we need to be on the same side of the table" mindset. There is no question that since we formalized the structure and made it discretionary, where we now make all the buy and sell decisions, that clients have been better served. In a weak moment, I also chose to grind the management fee to a whopping ½% per annum.

  The mandate is applicable to non-registered or taxable accounts and because we get the Canadian dividend tax credit it has the effect of juicing your income on an after tax basis, which in reality is the only basis that counts. The current yield on the portfolio is ~4% (3.5% net of the fee) and if you are a BC resident with a taxable income of sub $48,500 per year and Canadian dividends were your only source of income, you would be paying absolutely no tax. Even if you are at the top tax bracket you would pay tax at 36.5% on that 4% versus 53.5% on say your 1% GIC. On a side note, because of the way our cross border tax system works, our US citizen/Canadian resident clients also get a tax advantage.

In terms of the Canadian preferred share complex, it continues to shrink with supply drying up, which has obviously helped prices. Last summer, the Office of the Superintendent of Financial Institutions (OFSI) allowed Canada's banks and insurance companies to start issuing Limited Recourse Capital Notes (LCRNs) which is a cheaper source of funding and thus they are calling in their most expensive preferred share offerings as they mature. It argues for higher prices ahead as does the recent bump in interest rates because 75% of the Canadian preferred market becomes more attractive as rates rise.

- **The Keep More Income (KMI) Strategy -** or KMI for short, again developed for the income seeking investor that wants the tax advantage of the Eligible Canadian Dividend Tax Credit. Unlike TAPS this mandate focuses solely on common shares of Canadian companies and as such is a less income/more growth oriented program. It will be more volatile. In part, we developed this program for non-registered/taxable accounts to take advantage of what I see as Canada's next super cycle. Unlike the TAPS program, there is an argument to be made for having a slice of this strategy within registered accounts, especially if that is where most of your liquid net worth is located.

- **The Global Active Macro ETF (GAME) Strategy** – the genesis of the GAME strategy was developed in the back of my mind when I was attending the school of hard knocks during the bear market of 2008/09. I swore to myself that this would be the last recession I ever willing participated in. In short, I want to develop a program that would force me out of markets when systemic risks were developing and there was just nowhere to hide. The strategy is a follow the money process that forces us to buy into sectors that are receiving large inflows of cash and thus pushing prices north and forces us to sell when the opposite is occurring. We do it with a limit of 10 exchange traded funds and we adjust monthly. Let me be clear, I would never put 100% of a client's money into this – it is a diversifier, most suitable for non-taxable accounts because the turnover is understandably high. The strategy first got going back in 2017 and last August, our guru, Alex Vozian spent a lot of time improving the process and not surprisingly, the returns got better and more consistent. Hire good people and get out of their way ☺. The YTD returns for most accounts have pegged in 15%.

- **The Next Cycle Resource Fund (NCRF)** – first got going in January 2020 because I was already convinced that Canada's next super cycle was underway given the decade plus long bear market in commodities. In short, the cure for low prices is low prices because it dries up supply and reinvestment in the sector. We have seen this play out since the peak oil prices of ~$150 per barrel in May of 2008. By March 2020 down came the doghouse with the Covid-induced recession, which only further dried up reinvestment and I would argue, shortened the cycle. For history buffs, the average peak to trough commodity cycle is 14 years. May 2008 to May 2021 is 13 years. Look across the world today and what do we see? Record high natural gas prices. During the month of September we saw Alberta's AECO benchmark spot price move north of $4.50 per thousand cubic feet and just a short two years ago there were periods when producers had to pay to have it taken away. Alberta's oil producers are seeing the highest prices they have seen since 2015 and they are looking forward to improved egress from the start up of Enbridge's line 3. Meanwhile, both China and Europe are seeing electrical blackouts due to energy shortages and the UK can't get its petrol to the fueling stations. I'd say, "Houston, we have a problem." Yes, the transition to green energy will continue but it is not going to be anywhere near as fast as the promoters would lead you to believe. Furthermore, to get there we need lots more lithium, copper, cobalt, nickel and a myriad of other things that we are going to have to rip up the earths' crust to get. Responsible, green-oriented, resource companies and their shareholders will be the beneficiaries. This will not be for the faint of heart – there will be some ugly corrections along the way and it would not surprise me one bit if the next recession is caused by high commodity prices – you heard it here first ☺.

We are off to track #5.

Track #5: The Wrap Up – Buckle Up, It Is October

First the takeaways:

- The opinions expressed are mine, they may differ from Raymond James Ltd and undoubtedly, some of them are going to be wrong. It is just a natural outcome of this business. When we are wrong, we fess up and move with the evidence.
- Big Picture – copper and the semis are painting a mixed picture – the supply disruptions, high energy prices and blackouts raises our sense of caution. Interest rates have broken north and our loonie is pretty oversold – we expect it to bounce by year end barring an energy price recession. Recall that October has a reputation of being volatile but that is in front of the seasonally strongest 6 months of the year. Opportunity, not problem.
- The Dividend Value Discipline™ - Pool Corporation is a great example of everything we look for in an investee company – we covered their culture, their moat is full of crocodiles and those crocodiles are reproducing like rabbits. Covid has certainly accelerated the tailwinds and they score well on the ESG front. All of that has allowed them to drive the rent cheque growth at strong double digit rates – we expect more of the same.
- The Complement Strategies – I won't highlight each one – suffice to say we are in a position to meet most client needs with our in-house strategies where you get the comfort that when I buy for you I buy for me – same time, same price. Ditto on the sell side. Where we can't meet a specific need, we do have a limited menu of select third party money managers to round out our offering.

That brings us to a close for this edition of The Quarterly Opportunity Update. A reminder, if you are being introduced to us by way of this recording, then Tracks #6 and #7 are for you. Thank you for taking the time to listen – I trust it has been insightful. If you have people in your life who you think might benefit from these missives, please forward them as you see fit. Alternatively, they can sign up through our website, where all that is required is a first name and email address. Alternatively, they can book some time at **Book Appointments**.

This is Chris Raper, wishing you a wonderful thanksgiving, hopefully with the ones you love - good day and may God bless from Victoria B.C. on Monday, October 4th, 2021.

Track #6: Postscript I – Our Approach

While this recording has been focused on investments that is not where we start with new relationships. We start with your story, and we revisit it often. Knowing where you came from and what you want the future to look like – your do, have, and legacy ambitions – is the foundation for building a solid client/wealth advisory relationship. Our first order of business is to listen, seek clarity and then document your ambitions for the future – we call it, ***Your Story, Revisited***.

From there, we complete a 360º review of all relevant investment, tax/estate and insurance documents in an effort to identify gaps/risks to the future you envision. When we identify holes, we have a discussion about how we might fill those holes.

Then and only then do we get into a discussion on the investment allocation. We will address your liquidity, income and growth requirements/desires and introduce you to the tax smart investment strategies to meet those needs.

After we invest, it is a matter of manage and measure – we report regularly and when life throws you the inevitable curve ball or your priorities change, it is back to revisiting your story.

In summary, we learn about you, your family, your finances and what your ideal future looks like – the things you want to do, the things you want to have and the legacy you want to leave. We identify the structural risks and how we see mitigating them. We paint a go forward picture with a worst case analysis of the costs involved.

Generally speaking, we are looking to establish relationships with new clients that have north of $1 million in investable assets, but please understand that we are a lot more interested in where you are going than where you are. If you have a credible plan to get to that number say within a three to five year period, we are very interested in meeting with you.

So…if that process sounds engaging, I invite you to call and book some time. If you'd like further information, including access to our quarterly communication pieces, you can check us out on the web at www.chrisraper.com and send us an email from there.

Track #7: Postscript II – The Dividend Value Discipline™ Methodology

The first thing I want to share with you is that **The Dividend Value Discipline™** is our core mandate – essentially, all of our clients have a slice of their portfolio allocated to it. For your awareness, we currently have several strategies that we manage in house, in addition to a short list of 3rd party money managers. Structurally, most clients have three buckets of money with us – a safe money bucket, an income bucket and a growth bucket. **The Dividend Value Discipline**™ straddles the latter two and depending on your needs, we augment it with other strategies. The program continues to be a large slice of our client assets under management and in my case, it is by far the largest.

The process is discretionary, meaning we make all of the buy and sell decisions and report to you after the fact.

Our objectives for the program are:

1. Income every month – that can be paid out or reinvested;

2. An acquisition process where we buy only those securities which become attractive on a "go forward" basis;

3. Absolute returns of 8%+ over any investment cycle, which we would describe as peak to peak or trough to trough. If you are looking for a time frame in terms of years, think 5+ years, but please understand investment cycles have a wide range of timeframes.

The program operates with three key elements and I will walk you through them using the illustration of a three legged stool.

The First Leg is Dividends

With few exceptions, every security that we buy must provide some form of income. We do that because income makes portfolios inherently less volatile, i.e. less chance of loss. The analogy I like to use is that of an apartment block versus a piece of raw land – it is a lot easier to hold on to an apartment block in a tough real estate environment when you are getting a rent cheque every month. Income drives stability and absolute returns.

The Second Leg is Value

Our research function is in house. When we launched the program back in September of 2002, we were one of the first private client teams in the industry to have a dedicated analyst on staff and we add additional resources every year. We spend an inordinate amount of time studying the corporate culture of potential investee companies. If you are interested in what great corporate culture looks like, I encourage you to read ***Good to Great*** by Jim Collins – that is the yardstick we use to measure potential investments against. Another yardstick is the importance of wide economic moats – the things that make the company tough to compete with. We want to own companies that the end client can't live without – great examples might be Microsoft or Intuit, both long term holdings of ours. We believe that the focus on great corporate culture and wide economic moats gives us an edge, and while I can't prove it you I can certainly give you lots of anecdotal evidence to support that thesis.

The more recent development in our strategy has been tackling the growth problem. History buffs will note that when we started the program in 2002, we had 5-year GICs yielding roughly 5% and much better economic growth, whereas today we have 5-year GICs yielding of ~1.5% and much slower economic growth. In short, the 8% is tougher to come by.

Accordingly, we spent late 2015 and 2016 tackling the growth problem. We needed to find companies that were growing far faster than the economy. As you would expect, we started within the normal confines of "has to pay a rent cheque, score well on the corporate culture front and have some sort of strategic advantage (moat) that makes the company difficult to compete with". We then focused on those companies that have demonstrated their ability to grow their earnings/dividends at double-digit rates as a primary indicator of income growth and capital gain potential. As we searched, we found that most such companies fell into one of two themes. They tended to be disrupting the existing marketplace (think Wal-Mart 20 years ago or Amazon today) with a better way of doing things, and/or they tended to be aggregating their way to growth by buying smaller tuck-in acquisitions, much like Constellation Software Inc.

The Third Leg is Discipline

Here I refer to the buy/sell decisions.

On the buy side, I would sum it up as “do your homework, be ready, be patient”. Over the years our absolute best buys have been when we have done our homework on the company, perhaps months before, and then some untoward event happens that gives you opportunity to buy in size. The Euro debt crisis in 2011 is a great example that enabled us to buy Nike at a terrific price because we were ready and we had conviction. More recently, I would put he world’s #3 French fry maker, Lamb Weston, in that category.

Sell decisions are getting increasingly tougher because the quality of our companies just keeps going up and with their rent cheques (dividends) growing at double-digit rates, our history tells us more often than not that we are better off holding than chasing shiny baubles. That said, new competitors with disruptive technologies can wreak havoc on a company’s growth prospects – back to the Amazon/Wal-Mart example. Transition periods of senior management teams can be risky, especially when there is no hire-from-within bias. Then there are times when the price of a stock just gets so far in front of its growth prospects that the only reasonable thing to do is sell. As Buffett likes to say, “You pay a high price for a rosy consensus”. When things are universally rosy we try to be sellers, not buyers.

Perhaps the most important part of the buy/sell discipline is the way we operate the program for new entrants – we call it “The Buys Only Mandate”. Unlike most of our competition, we only buy those securities which become attractively priced on a go-forward basis, meaning if you start today and your brother starts three months from now, your portfolios are going to be different in the short-term, and more closely aligned the longer you are in the program together. As rational as that might seem, most people do the exact opposite. Every time you buy a mutual fund, you buy a pro-rata share of an existing portfolio – by definition, you got the buys, the holds and the near sells. To us, that is not rational. Who buys 100+ companies in a single day? Were they all great value propositions? You should also be aware that most third party money management programs work exactly the same way – they buy the basket. The buys only mandate was designed to protect your hard earned money.