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First Quarter 2014

This quarterly letter is shorter and later than usual as I've had a close encounter of an unimportant kind with the healthcare system. Even long scheduled successful minor surgery has been enough to reaffirm my belief that nurses are heroes. As Warren Buffett has observed, why society chooses to pay genuinely important people like nurses (and teachers, another personal favorite of his and mine) less than finance people like me is a wonder. In any case in this letter after a cursory review of the first quarter I will revisit the topics of behavioral finance (psychology combined with finance) and low cost index investing.

The first quarter of 2014 was something of a flipside to 2013. Bonds and interest rate sensitive stocks like Utilities which were bad last year, did quite well in the first quarter. Energy and mines (Materials) which were ugly last year were two of the best sectors in the first quarter. Last year's high flyers began this year strong but have faded mightily in the last few weeks. (It should be said that unfortunately we don't own any of last year's crop of high flyers, biotech and internet stocks, as I seem to get melted if not burned when I try to fly high.) It of course remains to be seen whether the recent weakness previews a general decline in stocks. It seems like years (three) since there has been a decent 10% slide. As you probably know I have a superstition about seasonality in the stock market as it seems that about three out of four years stocks tend to peak in the spring and bottom in the gloom of fall. Sell in May and go away, come again after Labour Day. The only real significance of that seasonal pattern for me is that I will restrain myself from doing a touchdown dance to celebrate a positive first quarter.

With varying degrees of commitment I try to practice what Warren Buffett and others of his ilk preach. This year's Chairman's Message in the Berkshire Hathaway Annual Report had some very good advice on investing. Some of you noticed that Buffett advised that non-

professional investors like the trustee of one his wills' bequests to his wife "put 10% in short-term government bonds and 90% in a very low-cost S&P 500 Index fund." This is not how I've invested your savings and because the topic of index investing comes up so often I thought that I should explain why not.

This year Buffett also recommended investing "in stocks as you would in a farm". An old adage is "investing is like a bar of soap, the more you handle it, the smaller it gets". One of the problems with investing in indices is the urge to do something can be very hard to resist, especially in a fast rising bubble or in a crash. The fear of regret, either of missing out on something or, worse, of losing something, can be a very powerful motivator. Markets can only be efficient if investors are unemotional. After all, the only reason to invest in something as abstract and impersonal as an index is because it is going up. If it doesn't go up the temptation must be to sell. My hope is that by buying stocks for the long term based on clear criteria (e.g. consistently high returns on invested capital and high free cash flow yield) and a defined investment philosophy (a steady balance between stocks, bonds and cash), my clients and I will become attached both to the investment process and the investments. One example I like to use is Walt Disney. My children have enjoyed the same Disney classics that I enjoyed decades ago and, many more besides. Disney keeps layering on new hits and compounding the value of its library. Any visitor to a Disney Park this year (my due diligence don't you know) will be impressed by the number of costume dresses from the movie **Frozen** being sold. I hope also that over time an investment in for example Walt Disney becomes more than just a number or an annual return. Knowing that the probability is that Disney year after year will keep making movies (although the frequency of hits will vary) makes it easier to stay attached to that investment, crop after crop, season after season.

Another of the difficulties in investing in stock market indices that I see is not knowing which index to choose. Recency bias, the tendency to extrapolate recent results into the future, can lead to bad moves. The S&P 500 represents the giant US companies and they tend to be very thoroughly studied. That may be the most efficient space in the global stock market. However, Canadians found it very hard to stick with US stocks in the first decade of this century as the Canadian stock market did so much better, seemingly year after year. I kept hearing about all of America's perceived failures and Canada's advantages. In the noughties decade Canadians could easily rationalize selecting the Canadian stock market index but how many would not have second thought that same choice during the decade of the 90's when the S&P TSX was getting trounced by the S&P 500. Similarly the temptation has been great to invest in various sectors at various times – Internet last year, perhaps Gold the year before that. Proponents of index investing can argue that one way to get around the problem of picking the right index is to invest in the widest possible index – the world's. Even after the surge in stock prices over the last year and a half the MSCI World Stock Market Index had a annual price return of only minus 0.7% (1.2% in $US) over the last 14

and a quarter years. I will submit that would have been very hard to stick to when other strategies and other investors appeared to be making money here there and everywhere

Sincerely,

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