Small Cap Update

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Keeping us on our toes!

One of our long time supporters in the Fund recently sent us an e-mail inquiring about some of our holdings. We thought that instead of giving you the usual macroeconomic outlook we'd share our thoughts on the things which matter most, individual company investments. For disclosure, we have paraphrased some of the dialogue.

Hi QV, I have spent some time looking at the small cap portfolio and have some questions, perhaps even concerns. You have done a great job over the years and would like to know your thinking on a few of your holdings.

Q: EL Financial

This stock has virtually no trading, was trading at $674 last April and now is at $530. As it is not very liquid, how do you get out? And what price are you looking for? I always think of small cap as more active investing and wonder how this fits?

A: EL Financial is a name that has been in the Fund since inception. In 2000 the shares traded at $120 and got to a high of over $700 in 2007. You're right, it is not a big trader and we could care less given the appreciation we have had over the years. This does not mean we have not taken profits over time, but it is more important to invest in a quality business rather than a business which trades lots of shares. It would be very difficult to sell out of our position if something went wrong. That is a risk we take with the style of our investing. I think it is less of a risk than buying marginal businesses which you can trade out of easier. With the recent correction to the low $500's the stock is now trading at a discount to book value.

Q: Leon's Furniture

One of your largest holdings is a stock that has been flat for two years. Do you see real growth potential here? Should you have this much tied up in a flat stock?

A: You know you're right we should not have this much tied up in this flat stock. We should probably have twice as much!!! Leon's is one of the best retail businesses in North America, period. If you look at how they have consistently built profits over the last decade it is very impressive. They have done so with zero debt and a focused disciplined strategy. Insider ownership is around $500 million telling us they treat shareholder money like it's their own, since much of it is. In respect to the growth, Leon's has just over 6% of the Canadian market share so growth is not a problem. I can only hope these shares pullback to offer us an even better buying opportunity.

Q: Empire Company

The shares of Empire Company have fallen from $55 in April/07 to less than $40. What would be the trigger for a sell?

A: great question as we always say the toughest thing we have to do is know when to sell. It feels like you always get it wrong, either it's too early and the shares keep going up or it's too late and you've seen your profits evaporate. As far as our selling criteria go, a loss of confidence in management, imprudent use of leverage (debt), a change in business focus or strategy, and valuation all go into making the sell decision. It is our preference to hold positions indefinitely but we realize the markets may offer you the opportunity to lock in profits from time to time or it may be prudent to manage the weightings of positions in the Fund.

You may recall that we were very defensively positioned last year in what we anticipated might be a challenging market. Empire fit the bill for us as the valuation was low and its grocery business relatively stable. Our hope was this defensive consumer staple would protect our Fund's dollars in a potential difficult market. In fact, that's exactly what happened as the shares traded from $40 to the mid $50's. We did actually sell some stock over $50 last year as this defensive name had grown so large in our portfolio and the valuation was fair rather than a bargain. Sure enough looking at the share price today in the high $30's we didn't sell enough!!! Now you see why we say selling can be so difficult. The biggest reason is you always have 20/20 hindsight to evaluate your decisions. If we would have sold more shares we could have definitely locked in some short term profits.

The shares of both Leon's and Empire have tripled over the past 7 years and EL Financial has increased by even more. We have said that the past 15% or 20% returns we've achieved in the Fund are not sustainable year-in-year-out and this is what you are witnessing with the three names you've highlighted. We could have likely looked at these companies in 2000 and found they were either flat or didn't trade many shares and made a horrible mistake in selling them. We have gone through a wonderful cycle in the equity market, particularly in Canada. It is normal to see these companies "take a breather" in the stock market. The key though is the health and growth of the business rather than the stock. The market will do what the market will do in the short term. Could we have sold some of these positions at higher prices and locked in more profits? Yes, maybe. But then you'd have to assume we're smart enough to buy back in and do this consistently. That's a big assumption!!!