

Donkeys and Wise Investors

Ned Goodman counsels patience in range-bound (and volatile) markets

BY MARK NOBLE

What worked in the '70s can work today – a disciplined investment approach that focuses on buying solid businesses at a great discount to their intrinsic value – according to Ned Goodman, founder and chairman of DundeeWealth.

In an address to the Toronto CFA Society, entitled *My Perspective*, Goodman told an audience of current and aspiring chartered financial analysts that since 2000, stocks have been in a range-bound market similar to what he experienced during his first years in the business managing money with Beutel Goodman.

“I call my process FocusPlus investing. It’s not rocket science, but it requires a lot of discipline and a lot of patience,” he says. “Patience is the most difficult part of the job. Patience is a virtue for donkeys, good husbands and for wise investors. When we find a good business that is run by people with good integrity, and we can

buy it at a price that is about two-thirds of what we think it’s worth, our job is done. From there on in, we wait.”

Stretching back to the pre-dot-com market highs, Goodman points out that the recent bull market has really offered a relatively flat return. He says the trend is reminiscent of the investing period he experienced from 1966 to around 1982, when inflation was high and corporate growth was flat.

In those days, finding yield was difficult because inflation ate a large portion of the gains. Today, the Federal Reserve has set interest rates low, but prices of commodities have soared, devaluing money and making profits difficult for businesses to achieve. Goodman says this investing climate could pay off for the patient investor.

“We are going to live through a period where profit margins are

going to be tough, because I think we have a whiff of something called stagflation,” he says. “Beutel Goodman did very well in that environment. We built a business that obtained \$15 billion in managed assets between 1966 [and] 1982, and we performed very well during that period. We performed because we were basically valuers of companies, not market mechanics.”

Goodman claims to use the same investment approach today, seeking out companies that are “ugly, unloved, underowned and undervalued.” He believes this investment approach will always outperform investment styles that closely follow portfolio management theory and the efficient market hypothesis.

He warns this is not a recommendation to start buying today, but the market may offer select bargains in the near future. He says that the markets have likely not yet bottomed out and that the recent plunge by the financial sector is making the markets look cheaper than they are.

For instance, the TSX as a whole is undervalued by about 11%, based on 6% growth projections

and a 6% discount rate. That’s still a far cry from his preferred discount of 30%.

“Stock prices today are not expensive, but they are not cheap,” he says.

Recently, his investment process was dubbed “exotic beta,” a style of investing that eschews modern portfolio theory and believes markets are not efficient. Goodman says not long ago he read a *Financial Analysts Journal* article written by Robert Litterman, managing director of Goldman Sachs, that outlined exotic beta in detail.

“[Litterman] said exotic beta refers to the passive exposure to a risk factor or asset class other than the market portfolio, the market class or the market beta. As such, exotic beta can rely on a largely passive exposure to less mainstream asset classes,” Goodman explains.

“Exotic beta is what I do. Exotic beta is what Seymour Schulich does. Exotic beta is what the Beutel family does today. That is, not using modern portfolio theory – it’s working around it.”

Goodman says investors should

defy academic conventional wisdom, like modern portfolio theory, the capital asset pricing model and efficient market hypothesis, because he knows “everybody else is using it and trying to make money at it.”

The problem with applying this investment philosophy, though, is the strict adherence to the efficient market hypothesis by many accountants, which Goodman believes has contributed to some of the current troubles faced by the financial sector.

The rise of mark-to-market valuations, which require companies to account for market losses and gains on their holdings, draws Goodman’s ire.

“It’s the principle of market efficiency that provides the academic cover for all that mark-to-market madness that all of our financial institutions have had to eat in the past few months,” he says.

“The accountants have done it again. The whole process that has required mark-to-market accounting is basically buying into the efficient market theory.”

Goodman expects this type of accounting to skew financial results further as more international systems of accounting, such as International Financial Reporting Standards, are adopted.

“I’m concerned about how the results of the banking industry are going to be portrayed in the future,” he says.

Goodman is skeptical about the prospects of the financial industry in general, saying a decision by the United States Federal Reserve to accept subprime-exposed investments as collateral for liquidity loans is more like morphine than a cure for a sick industry.

“It caused Dr. [Ben] Bernanke to panic – and let’s not look at it any other way – two weekends ago, he was in a panic. We were in a crisis of confidence. He had to restore confidence, and he has done so,” Goodman says. “It does not get to the root of the crisis, which is based upon mountains of excess credit of dubious value.”

For now, Goodman says he’s invested in commodities, adding that the boom fuelled by developing economic superpowers should continue for some time.

“We can look at the onset of China and India as another transition that has taken us back to the commodity market,” he says.

“We are invested in energy, agriculture, special situations and gold. We are comfortable there, and we are staying there.”

Fund Wrap

Wild swings in the equity markets, fuelled by fears of a recession in the U.S. and the spectre of collapsing American financial institutions, made mutual funds a tough sell in March.

Net sales of mutual funds for the month are estimated to be between \$2.3 billion and \$2.8 billion, according to preliminary data from the

Investment Funds Institute of Canada (IFIC).

Worst hit were foreign equity funds, which were pumelled during the first quarter of 2008. Many of the world’s markets had double-digit losses for the three-month period, but for Canadian fund investors the blow was softened by the Loonie’s steep drop against most major currencies during that time.

One of the few bright spots in the first

quarter was the Global Fixed Income category. The funds in that category gained an average of 6.8% in those three months, which was the best return among all 42 Morningstar Canada Fund Indices. The result is net assets under management by the industry estimated to be between \$681.8 billion and \$686.8 billion – up about 0.83% at the end of February.

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MORNINGSTAR FUND INDEX

As of March 31, 2008	1M	YTD	As of March 31, 2008	1M	YTD
European Equity	4.6	-6.1	Canadian Short Term Fixed Income	0.5	2.6
Real Estate Equity	4.3	-1.7	High Yield Fixed Income	0.5	-1.5
Global Fixed Income	3.8	7.5	2015 Target Date Portfolio	0.3	-2.3
Canadian Inflation-Protected Fixed Income	3.5	4.9	Canadian Money Market	0.3	0.9
Science & Technology Equity	3.0	-11.8	Canadian Neutral Balanced	0.3	-1.4
International Equity	2.8	-7.8	Financial Services Equity	0.3	-9.3
US Equity	2.8	-7.6	Global Small/Mid Cap Equity	0.2	-8.1
North American Equity	2.7	-6.1	US Money Market	0.2	0.8
Global Equity	2.2	-6.8	Canadian Focused Equity	0.0	-4.5
US Small/Mid Cap Equity	1.8	-9.5	Asia Pacific Equity	-0.2	-8.6
Global Equity Balanced	1.6	-3.5	Asia Pacific ex-Jpn	-0.2	-10.3
Canadian Long Term Fixed Income	1.4	1.5	Canadian Equity Balanced	-0.2	-2.8
Global Neutral Balanced	1.2	-2.8	Tactical Balanced	-0.2	-4.2
2020+ Target Date Portfolio	1.1	-2.6	Health Care Equity	-0.3	-7.2
Japanese Equity	1.1	-6.4	Canadian Dividend & Income Equity	-1.0	-5.0
Global Fixed Income Balance	0.9	-0.3	Canadian Equity	-1.4	-3.9
2020 Target Date Portfolio	0.8	-1.9	Emerging Markets Equity	-1.6	-9.0
Canadian Fixed Income	0.8	2.5	Natural Resources Equity	-2.2	1.8
2010 Target Date Portfolio	0.6	-0.5	Canadian Small/Mid Cap Equity	-2.3	-5.2
Canadian Income Trust Equity	0.6	-0.1	Cdn Focused Small/Mid Cap Equity	-2.6	-6.9
Canadian Fixed Income Balanced	0.5	-0.2	Precious Metals Equity	-7.6	4.4