ADVISOR Q&A

Valuing Partners

AIC offers same old philosophy, but with a focus on execution

INTERVIEW BY SCOT BLYTHE AND MARK NOBLE

AIC has been in redemptions for a long time. Mark Noble, Scot Blythe and Romana King asked CEO Jonathan Wellum how AIC plans to reach out to advisors, and where subadvisors fit in.

Q Why did AIC fall out of favour with investors?

A Obviously it's a big question. Some of that pressure would have to do with the sectors that we focus on: We buy long-term, value-oriented businesses, and typically we are significantly underweighted in commodities – now, if you look at the Canadian market, it's heavily dominated with oil, gas, minerals, and gold – which has come into favour with concerns over the U.S. dollar – as well as agriculture and commodities. You've got big, big moves in areas where we just don't spend a great deal of time.

Q Is there any way to use value investing in commodities?

A We've had some exposure, not zero exposure, in the commodities area but I think it is more difficult to apply a value approach. We did buy oil stocks quite a number of years ago when pricing was at $25 a barrel. When we started going in, there was true opportunity for upside. But when you get into extremes – $135 going to $200 – as a value investor, looking for a large margin of safety, it's very difficult to maintain big positions. It's difficult to know how much is speculation or shorter-term pricing pressures that will be alleviated by production increases and substitution (and so on). It is an area where there have been some great investors that have gone in and done very well, but typically it's not an area we put a lot of horsepower into since it is hard to forecast commodity prices.

Income trusts are another big area in the marketplace – over the last five years there's been a big rush, but it was not an area we were enthralled with for a whole host of reasons.

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>
> **Jonathan Wellum**

Conversely, some pressures existed where we have been – like financial services – because of credit and liquidity concerns. When half of our assets are in financials – our numbers got hit pretty hard in '07 – it's very hard not to trail the marketplace.

Q What about non-market issues?

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A Another issue that was self-imposed was too much turnover in our core business – not in marketing, back office or even portfolio management, but in the sales side. [Sales is] the important liaison with the financial advisor. When you have that kind of turnover as we did in our business, it raises concerns with advisors over stability. We have to do a better job at executing and building our sales relationships.

Wellum

Q What is your strategy to turn things around?

A We have to come to the table with an incredibly compelling proposition: when you come to AIC you get one investment philosophy – value investing: a disciplined, long-term approach. [With AIC] we're going to bring to you, under one roof, the absolute best value investors that you can find. So when you come it's not just the AIC in-house team doing everything, it's about partnering with companies that have storied histories and strong reputations; they've been in business for a long time and have proven execution.

That's why we brought in Third Avenue, Ariel, Loomis Sayles, and now Brookfield Redding, and we've actually tried to put them on mandates that we believe are, not just unique, but really offer long-term value opportunities. Real estate, global infrastructure, that's a great space to be because of the nature of the assets – long duration, capital assets, that are fundamental to the growth of the economy.

> We are much more bottom-up, but we cannot understand a business if it's not put into context in its industry.

That's at the top level. Below that has to be products with features and benefits advisors are demanding; then we need to be able to service them. Even when you have the best products, we need to have a relationship with advisors and say 'you know we're here for the long term' – our follow-up is important.

Q How do you see things turning around?

A We do need a little bit of help from the markets, when it comes to financials. Third Avenue now has a three-year number that is better than Cundill, better than Brandes, it's one of the best out there – so it's coming together. But clearly we still have a lot of assets in financials and we're not going to change that, on our core funds. We believe that banks, insurance companies and wealth management firms are strong places to be over the long term and in fact this credit liquidity issue is going to make the stronger ones stronger, and we'll have a good period for the opportunity for growth as they get recapitalized. A lot of them will disappear or get merged, so from that perspective, getting through the worst of this credit issue, and getting better transparency, and getting financials recapitalized [is the goal] – the faster that happens the better for us.

Q Do you worry about transparency and disclosure in the financials?

A Yes, of course we worry. I think, though, that given where we have the majority of our assets, we've not been hit by the write-offs as much. We've had some exposure to Merrill Lynch and UBS, some of the big, bad boys, but relatively small. Our bigger exposure is in safer companies, the Manulifes of the world, the INGs, TD Financial which have come through this quite well.

It is frustrating, and its disappointing to think that [some] institutions did not have some sense of the kind of risk they were sitting on; it's one thing to be a vehicle of velocity, it's another thing to be, as James Grant, the editor of *Grant's Interest Rate Observer*, said, 'a storage facility.' And they were storing things that were somewhat toxic – they believed their own hype. It's disappointing rating agencies were not more thorough.

Q In value investing you are always looking for a margin of safety, how much do you have to take macroeconomics into consideration?

A It's impossible to be 100% one or the other. You have to contextualize – we are much more bottom-up but we cannot understand a business if it's not put into context in its industry.

Having said that, it's an issue of priority – Buffett and other value investors are a little coy if they say they don't care about overall economy. Clearly if there's pressure in the economy, you have to factor that into your evaluation.

Q A few months ago, you launched a few funds that turned some heads since the market has been having difficulty. Why?

A We launched five individual funds, and the Value Leaders package. The individual funds were in real estate and global infrastructure and then three financial funds.

Let's start with real estate. We've been looking at launching something in real estate for about three years, since we started working with Third Avenue – but we wanted to get our relationship going to so we launched our Global Focus Fund with Third Avenue, which literally was three years and a month ago. Michael Winer is really well known and real estate is throughout all of their funds. Over a year ago we talked to them about potentially getting a real estate fund going, but a year ago the market was frothy – so we thought, if we are going to launch a fund, we'll do it when the market gets weak.

Now, you have to remember that the real estate they are talking about is industrial, commercial, global, it's not homes on the beach in Florida. It's exposed to the credit market and responds to the economy but it's not nearly as vulnerable, problematic or volatile as [other] areas. So first, you are finding a great team that is going to take advantage of an area that is down 30%. [Also] Third Avenue likes to focus on operating companies because they don't pay out all their cash (this hampers the balance sheet and their long-term growth prospect).

In this market, if you're liquid and capitalized you're in a huge winning position in the next five to 10 years. Just like Buffett and what he's doing with all the liquidity he has.

[And] it makes perfect sense to launch when things are the weakest – we are value investors – if we don't and wait for things to come up 30%, then we've taken out a lot of opportunity on the upside.

On the infrastructure side – that came out of discussions with Brookfield Asset Management. We talked about doing something on a closed-end basis, but that was going to be hard, to get their institutional portfolio into a retail setting, so they said 'look, we have this company in Chicago that's our 100% subsidiary, looking for investors, and they run a publicly traded securities portfolio.'

In the next 20 years, there will be so much money passing into infrastructure; also real estate, and global infrastructure is less correlated with financials. That's important to our business model.

Q Is there enough room in those spaces given the diversification efforts of pension funds and sovereign wealth funds coming in?

A We do believe there is room, because the level of spending will be so large, that the public markets will be a portion of the money raised. Yes, there is private; yes, there is SWF; but there will be public market.

There is so much money that just to keep the economy moving forward globally, with the industrialization in China, we're going too have to put money into infrastructure and there is enough room there for the public markets to get a piece of that.

The other three funds we launched are segmented products – banks, insurance and wealth management – to allow our investors to focus on those areas; we will also pick those up in our Value Leaders managed portfolios (the funds allow segmentation and facilitate portfolio construction). I think what you'll see over time is further consolidation and allowing some of these specialty funds to carry the weight over time.

> There is a lot less reason to have as many Canadian focus funds in our industry. Every Canadian company has some – but are there too many?

Q You mention consolidation, but given the level of buyout activity in the TSX, does it make sense to have Canadian funds anymore?

A I think there is a lot less reason to have as many Canadian focus funds in our industry. Every Canadian company has some Canadian focused portfolio – but are there too many?

We have four funds that would be in that space – but we certainly do not want to put out more Canadian content.

Which is one of the reasons why all of our new products have a global orientation. That's where we see we have to shift our business and we have to have the best managers in the global marketplace, we can't pretend to know all the emerging markets, so we have to go out there and find the people with the expertise to do that.

The area that we are focusing on with our own in-house team is: global financials, Canadian bonds (with Randy LeClair) and Canadian equities (with James Cole).

Q How does Copernican closed-end business relate to fund business?

A Distribution. A number of years ago we did very well with the MFDA and IDA channel.

In the early 2000 period we focused more on the MFDA, and figured the IDA wouldn't sell too many mutual funds and thought they'd be more into wrap accounts, which is true, to a certain degree, but you still have a big growth in the IDA and there are still very large pools of capital managed by brokers in the IDA channel. Then you're getting this MFDA-IDA channel coming together: they're looking more alike. So back in 2003, we thought we have to do a better job at getting in IDA offices and talking to brokers. That's when the closed-end side came about, we put together a selling team and then went into the IDA channel. What we are finding now, paradoxically, is that large brokers are buying our global real estate fund. Same with global infrastructure – the biggest tickets are large IDA brokers – because they are looking for really unique funds and they appreciate Third Avenue and Brookfield-Redding.

Q Are you the same company or are you a different company now?

A Well, there is continuity and discontinuity. There is absolute continuity in investment, management, philosophy, principles and what we stand for, but people need to get a better sense of what goes on behind the scenes and make sure that execution is going to be consistent.

Q What strategies do you have in place to ensure those subadvisor relationships?

A People ask what kind of legal contracts do you have, and my response is: if you are relying on a legal contract, forget it. We have a good legal contract, but at the end of the day, you are not going to work with a subadvisor because of a legal contract.

You're going to work together because, number one, you share similar values; number two, you develop deep relationships between the firms; number three, you pay them well. With Third Avenue we set up an agreement with them and we've shot through $600 million and they are making the same on dollar one as they are on $600 million and we are quite happy with that. They get well paid and could not come into the Canadian marketplace and generate the same level of revenue on their own. Companies like Ariel are a $12 billion company. They don't really want to go into Canada, they'd much rather do it as a subadvisor.

Q Will Michael Lee-Chin sell?

A He's been very adamant. I'm his CEO so I have to raise the question, does it make the most sense? Do you want to redeploy capital into higher return areas? It's one of the reasons he sold Berkshire. And he does not. He has absolutely no interest in selling AIC, provided we are doing our thing. [And] the company is now controlled through a holding company that Michael owns – part of his portfolio. **AER**