Checkmark Investing™

Heathbridge Capital Management Ltd.

In conversation with Rob Richards, Rupel Ruparelia and Richard Tattersall

as the principals exchange thoughts on how to truly look out for the best interests of their clients.

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This approach—which we call 'Checkmark Investing™'—was developed in the course of years of observing first-hand the best and worst practices within the North American money management industry.

In the following conversation, the partners consider issues commonly raised by their prospective and existing clients. They start by evaluating what they feel their clients most appreciate about their relationship with Heathbridge.

Richard:
Warren Buffett said that successful investing doesn't require extraordinary intelligence, it requires extraordinary discipline. People who have been with us for a while see that we don't jump after the latest, hottest trend and we explain to them why doing so would be perilous.

Rob:
I would say that point is really important. We really do offer something that is unique. Over the long term we serve our clients extremely well. For example, most of our clients were up year-over-year in the summer of 2009, whereas most of our competitors were still showing significant losses.

Our level of service is over and above the norm–and this applies to both the very big accounts and the very small accounts. For example, we've just completed work on GST rebates. The feedback we got was that most managers didn't provide the same detail or go to the same trouble that we did to accommodate our clients' needs. Clients appreciated it.

But at the end of the day, what matters most is our clients' confidence in us. That's what makes us different in a business where there is really very little to differentiate.

Rupel:
I agree. I think our clients value our honesty and integrity. They sometimes ask us about things that don't relate directly to their accounts. Because we disclose everything and don't have any conflicts, we're happy to be their advocates. We give them straight answers, as we see it, about why they should or shouldn't do certain things.

Richard:
I think our clients appreciate that we are seeking a lifetime relationship with them and are honest with them. For example, if we estimate that they're going to run out of retirement money in 10 years, we say, "You can't afford to have 50% of your portfolio in bonds because you're guaranteed to run out of money. If you take this path, you should consider working longer." These can be uncomfortable discussions. Clients sometimes say hearing the truth felt like being hit in the solar plexus, but they thanked us for bringing them into the real world. Just as a doctor may caution that you're going to die if you don't change things, we say you're going to face serious challenges if you don't make some changes. We then offer them some alternatives.

Summarizing our investment philosophy.

Richard:

Our investment approach is markedly different from most others in four aspects. Firstly, we tend to buy stocks of companies with strong fundamentals whose prices are down. Secondly, we have clearly focused portfolios. We think that if you hold twenty stocks and they are different from each other, you get the diversification benefit and you can control the differentness of the portfolio. Thirdly, our portfolios don't look like any index. Indices tend to focus on hot stocks and sectors with big weightings–for example, three-quarters of the TSX is in banks, oils and mines. We think investors should be nervous about putting three-quarters of their money into hot sectors. And fourthly, we look to longer time horizons. Some people think a three to four year investment horizon is too long, but we think that is how long it may take for solid investment opportunities to be rewarded by the market.

Rupel:

Money managers are often closet indexers who are trying not to be too different from everybody else. They effectively chase hot stocks because they don't want to underperform in the short run. Such short-term focus is not right for their clients over longer periods of time.

> *Ours is a unique approach: we calculate the client's required rate of return to get them where they need to go. Then we take that information and compare it with the rates of return inherent in each of the asset classes, and work out an appropriate asset mix. This approach leads to some surprising conclusions.*

Avoid falling knives. Catch falling pearls.

Rob:

One of the most unproductive aphorisms in the investment world is that you should never try to catch falling knives. Of course you shouldn't–you're going to cut yourself. But that's different from buying a stock when it's down. A better analogy might be this: as you catch pearls falling off the table, you pick up value. We say the time to buy a good company is when the collective mind has dismissed it. That's when the value emerges. You can't be afraid of a stock going lower after you buy it.

If a company is a pearl when it is priced at $100, why do investors not see it as a pearl when it's priced at $10? Usually, this is because of a recession or a loss or an accident. The theory of efficient markets is true to some extent. When a stock is $100, it is pricing in all the good news that is known about the company; when the same stock is $10, it is pricing in all the bad news. But we know it's the same company with the same attributes, so we also know it's only a matter of time before the news turns positive again and people start to chase it.

Richard:

We're often asked how we determine which companies are the pearls. We go through a checklist to assess the company in three areas. Firstly, do they have a long-term competitive advantage? Most companies fail that screen because they're really not great companies. Secondly, do they have sufficient financial strength so they're not reliant on the capital markets or the banks during uncomfortable times? And thirdly, we look for good management, which we define as being capable of delivering the potential of the company.

Rupel:

Going out to visit the companies, meeting the management, and talking to the suppliers is a very important part of the process. This means we don't have to rely on an analyst's recommendation. In any case, what we're looking for is often different from what others are looking for–they may have different pressures or be on a shorter time horizon. We hold only one company in an industry and compare the others against that. People may feel it's safer to own five companies in that area, but that really just gives you that much more exposure.

The price criteria is very important to us. We often wait years before we purchase shares in a company to ensure we buy it at a good price. We may have identified that the share price has decreased for reasons we feel are temporary and believe the shares will recover. We become very interested when stocks are going down in falling markets.

Richard:

Although we only hold about twenty companies at any given time, we are actively tracking about forty because we're looking at alternatives. We get access to all the best research minds and tap into experts from a dozen different firms. Then we complement this knowledge by doing our own research.

Rob:

We focus on the research and investment side of the business, rather than the sales side. We have three Portfolio Managers who are extremely competent analysts. We know what the large firms do–I was an analyst selling to them for many years–we know how to do it and we do it very well. In addition, our system means that we don't need to do research that's not relevant to us: if we're only going to buy one company in each industry, we don't have to know all the companies in each industry. All we have to do is focus on the ones that we care about and the two or three that might be alternatives.

All three portfolio managers are CFAs with broad experience.

Rob:

All of our Portfolio Managers are Chartered Financial Analyst charterholders (CFAs). The CFA is considered the gold standard in the industry. This in my view confirms our commitment to our clients and the investment industry as a whole.

Rupel:
We have to abide by the CFA Institute's Code of Ethics and Standards of Professional Conduct. Our clients can take comfort in knowing that in addition to whatever undergraduate or graduate work we've done, we've also gone through a very rigorous program to get the CFA designation. It involves three years of financial and portfolio management courses, in addition to having the relevant work experience. There's a higher standard demanded of people who are taking this route and, in practical terms, you have the proper tools to analyze companies.
Richard:
The CFA program requires financial literacy as well as a knowledge of multiple disciplines, including economics, accounting, financial analysis, equities, and portfolio management. Only a small percent of applicants pass—so it acts as a kind of screen—and preparation for the CFA examinations involves a substantial commitment of time and energy.

Threats facing today's investor.

Richard:
Although there have always been threats of inflation and wars and government policies and economic calamity, the complexity of the financial world is increasing. Derivatives, for example, are very complex things. I think the fundamental risk for investors is that they need to understand what they're investing in, or have a portfolio manager who does. They should be skeptical of being sold products which have been put together to pay someone a commission.
Rupel:
I think one of the hardest challenges is managing client expectations when times are good. People ask us about new financial products and we tend to be very skeptical. It's hard to explain why someone's neighbour who has found an exciting new investment does better than we do—for a time. When we look at the investment, we often conclude that we're not interested because it's risky, very complicated or has very high fees.
Richard:
At Heathbridge our model is to align our interests with our clients. We invest alongside them and sniff out opportunities. Except for differences in risk profile, there is nothing in our portfolios that isn't in theirs, and vice versa.
Rob:
Our business model is very transparent, with full disclosure. Clients can calculate to the penny how much money they make. There are no hidden mark-ups on bonds. Clients own the securities directly, and once a month clients get to see everything in the portfolio–how each stock has done. We explain to clients in writing why we bought these securities. Contrast that with hedge funds, where you get nothing except a result on the pool. When the result is disastrous, they say, well markets are what they are. And the hedge funds are outrageously expensive–2% management fees and 20% of the profits in the pool versus our 1.25%.
Rupel:
We want our clients to understand what we do and why we do it. We have a good long term track record, and there have been times when we've had spectacular years. We want them to understand why–say, when we've bought a stock at $15 after it's dropped from $50–we're not worried when it drops further to $10. That's the process. We're still checking, we're still watching, and we're still making sure it's okay.

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Helping our clients prepare for an uncertain future.

Richard:
We do a rough block financial plan for our clients that tells them how much money they need and how to reach that goal. We are genuinely worried and concerned for our clients. When we look five, ten, twenty years out, we may say, "You're not going to have enough money. You need to make a course change and this is what you need to do." Often, that's not easy. It could mean working longer, saving more, or bypassing a private school education.
Rupel:
Once we've gone through the rough block financial plan with a client, we prepare an Investment Policy Statement (IPS). The IPS says, "This is who you are, this is your age, these are your goals and objectives, and this is the ballpark number we need to reach." You don't necessarily need a thirty page financial plan that shows you spent $22 on parking last month. We say that as long as you're saving what you need to be saving, we're less worried about where the rest of your money goes. That's your call, as long as you're not getting into debt. The IPS helps to govern how we manage the account.
Rob:
The IPS provides a financial framework for the client and governs our administration of his or her portfolio. We are not financial planners. Rather, we do a rough block financial plan to make sure we understand clearly how our clients' money should be invested.

Many industry professionals apply rules of thumb–for example, the percentage of equities you should have is 100 minus your age–which really have nothing to do with the job your portfolio has to do. We take a very different approach, because we understand the importance of having the right asset mix to reach your goals. We calculate the client's required rate of return to get them where they need to go. Then we take that information and compare it with the rates of return inherent in each of

the asset classes, and work out an appropriate asset mix. It leads you to some surprising conclusions.

You may want to have certificates of deposit in your account because you believe they are the safest thing to invest in. But if you're going to run out of money for sure, then they're not the safest thing. If equities give you the best chance of getting to where you need to go, then equities are the right choice. However, we prefer that people retire with a balanced account and a significant proportion of our clients have portfolios of sufficient size to permit this.

Our disciplined control of risk variables sets us apart. For example, we rate each client as to maximum tolerance for risk and rate each security as to its risk content. We match the risk of the securities in the portfolio to the client's risk profile.

What is becoming very evident is that the baby boomers do not have enough money to retire. As a generation, it has woefully undersaved. Their children are going to recognize this and I believe our culture will go back to saving the way the generation did before the baby boomers.

Richard:

We manage money for only 125 families and we know them pretty well. One of our newest clients said he decided to work with us because he liked our investment discipline and our ability to empathize with the financial responsibilities of raising and educating his children. We like to connect with our clients' children and help them to get on track.

Rupel:

Some parents say that the best gift they can give their children is to put them on the right financial path in their early 20s.

Closing thoughts.

Rob:

In summary I think we're a very good company. We are not a high cost operation. It's important that our clients know that we're very well managed. We've never had a quarter with an operating loss, even during the global market melt-downs that we saw in 2002 and 2008. We retain half our earnings, and are financially very strong. If we were a company we were looking at to invest in, we would meet our own criteria.

Why is all this important to our clients? Well, because they know that we're going to be here for a long time. We're not as vulnerable to the stresses that the industry goes through. They know that when the market's down, we'll be fine and will come out the other end.

We are different–and the difference makes us better.

What is Checkmark Investing™?

We call our investment philosophy ***Checkmark Investing™***. We distilled this discipline from first-hand observations of the best and worst practices of the money management industry in North America. Our strong, value-oriented strategy constructs diversified portfolios of companies screened for attractive long-term attributes and financial strength.

We consider price an extremely important criterion for maximizing returns and reducing risk. Consequently, we usually purchase securities after price declines.

1. Our research screens for companies with attractive operating attributes and strong financial positions.

2. We observe our target companies for long periods of time, looking for downdrafts in stock price to present buying opportunities.

We believe good companies must be bought at good prices in order for them to become good investments.

3. A company's share price may continue to decline further after our purchase. However, when we are correct about its long-term attributes, our investment's share price will eventually revert to an upward trend. This pattern of a downleg followed by a sustained upward rise forms a pattern resembling a checkmark.

4. We expect that a diversified portfolio assembled of sound investments bought at careful prices will provide strong returns and yet be resilient in downdrafts.

5. We trim or sell successful investments at predetermined prices to harvest profits and control our weightings in individual holdings.

Endnote

Heathbridge Capital Management Ltd. is wholly owned by its employees. We feel employee ownership fosters a culture of entrepreneurship and a focus on clients' needs.

We believe that corporate responsibility includes community support. Heathbridge Capital Management Ltd. donates 5% of its operating profits to charity.

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Heathbridge Capital Management Ltd. is a member of the Investment Counsel Association of Canada and the Institute of Corporate Directors.

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