It's about time.

Time is the most important element in the investment process and the most important factor in creating long-term wealth. Yet the importance of time is perhaps the least discussed concept in the study of the investment discipline.

While counter intuitive, the longer the time frame the higher the dollar return and the lower the risk. In our view any investment process and strategy with a time frame of less than five years borders on speculation. The shorter the expected time frame the closer the investment is to a pure speculation.

Long time frames are critical for the following reasons:

> **Time allows compounding to work in the investor's favour;**
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> **Time reduces risk because it allows for the investment thesis to materialize;**
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> **Time is a competitive advantage for the long-term investor because it allows for the exploitation of market inefficiencies caused by those with short-term time frames.**

As Albert Einstein once said "compounding is the eighth wonder of the world." And wondrous it is. The mathematics of compounding is straightforward but its effects are extraordinary; particularly when the sums are presented in absolute dollars. The longer the time frame the bigger the impact. For example, one million dollars compounded at five per cent for one hundred years becomes approximately $131.5 million. For most of us a twenty to thirty year time frame is more realistic. Using the same five per cent return over a twenty-five year time horizon turns one million dollars into approximately $3.4 million. A modest return more than triples the absolute dollar value of the portfolio; but the key is the time frame.

If we shortened the time frame to three years it would take a compound annual rate of return of almost fifty per cent to achieve the same portfolio value. This return would be very difficult to achieve without taking extraordinary risk!

As well, a small increase in the return increases the value of the portfolio over a long-term time frame. In our previous one hundred year example, simply increasing the return from five to six per cent increases the initial one million dollar investment to more than $339 million vs. $131.5 million. Over a twenty-five year period, increasing the return from five to six per cent transforms the original one million dollars into $4.29 million; more than nine hundred thousand dollars!

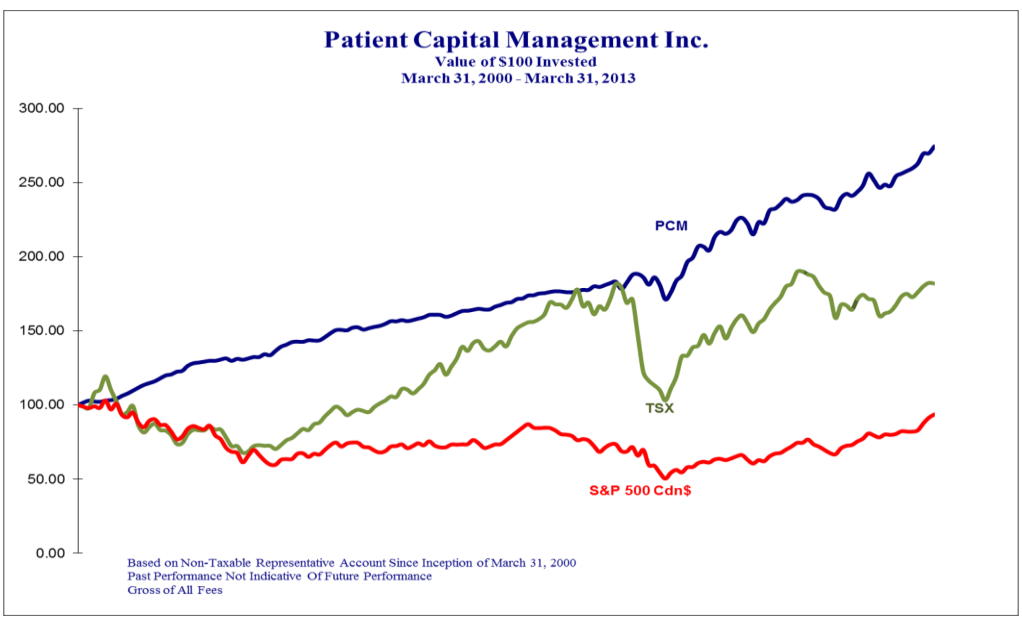
A long time frame reduces risk as it allows for the investment thesis to materialize. Typically our investment opportunities present themselves in times of uncertainty as a result of one of three factors; overall market uncertainty, industry turbulence or a company specific issue. In all cases, assuming proper analysis and favourable valuations, the longer the time frame the greater the probability of positive returns. Time allows for valuations to revert to their "normalized" levels, for industry issues to be resolved and for specific company problems to be corrected. It is quite unrealistic to expect that any of the above issues will be resolved in a short period of time. For example, we invested in the U.S. health care industry when U.S. health care reform was introduced more than two years ago. Our belief was that the new legislation would increase the number of people requiring health insurance quite dramatically and that the better companies in the industry would adapt their strategies and alter their costs to reflect the changing environment. Today, as expected, the industry has evolved to cope with the new legislation and other investors are now starting to recognize the economic value of these businesses and the share prices are now substantially above our cost.

A very important benefit of this longer term view is that trading costs are reduced and that holding securities over a longer term time frame is very tax efficient. Once again, over an

<u>extended period of time</u> even a small increase in returns due to lower costs and tax benefits improve portfolio values quite dramatically.

Having a longer term time frame gives us an enormous competitive advantage. Indeed it is because you have given us the privilege to manage your capital with a long-term view that we can stand apart from the crowd. We can effectively take advantage of the pressures that force our competitors to make short-term decisions. While others react to their immediate business or client pressures we can buy "dollars for fifty cents" and then patiently wait for the market to realize the underlying intrinsic value of the businesses that we own.

The absence of short-term performance worries is liberating! We can focus on letting the magic of compounding work in our favour without distraction and compromise. This competitive advantage is reflected in the graph below. It shows the power of compounding through PCM's returns. Over the past <u>thirteen years</u> we have more than doubled the value of our clients' portfolios. Because we have earned a higher rate of return than the TSX and S&P CAD, the long-term growth relative to our benchmarks is quite substantial.



Turning our attention from the long-term to the present; financial markets have been very strong over the past year and year-to-date. Equity prices have reached record highs. The Dow Jones Industrial Average has surged above 15, 000 for the first time. Government, corporate and junk bonds are all at historic levels; rising substantially as interest rates have fallen to all-time lows. The benchmark 10-year U.S. Treasury bond yields an interest rate of less than 2% and the average corporate bond yields just 2.7%. These interest rates are a fraction of their historical averages.

However, these extraordinary returns in both the equity and bond markets have created a serious intellectual inconsistency in today's financial markets. The surge in equity prices implies that investors are expecting very strong economic growth. At the same time the bond market is forecasting an economy mired in slow growth for the foreseeable future.

Both views can't be right and therein lies the risk. If the economy grows strongly, interest rates will rise; stocks and, especially, bonds will suffer. But if the economy doesn't boom as equity investors expect, stocks will fall because corporate profits will not justify today's very high valuations. (Please refer to our 2012 fourth quarter newsletter www.patientcapital.com/news for our views on the equity market's valuation and risk).

It's been our experience that when intellectual inconsistencies in financial markets exist they are eventually resolved. When these inconsistencies are resolved a sharp and often steep decline occurs. The resulting market environment typically provides attractive long-term investment opportunities.

We are patiently biding our time!

Vito Maida
May 23, 2013.