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SPECIAL REPORT

Swinging for Singles but not Hiding in the Dugout

I had an epiphany (of sorts) very recently.

I was seeing a prospect (now a client) in the U.S. with one of our senior client service/risk management professionals when the comment was made and question asked of us that went something like this: "You guys have done a great job pitching your firm, but if there was a criticism out there, what would it be? Everyone has at least one blemish."

I took this one on and said "I know exactly what the criticism would be of us, and I will gladly share the blame on this one. But if there were to be a criticism, it would be that we have focused too much on capital preservation. We have been too conservative."

The prospect-turned-client responded with … "that is exactly what I wanted to hear."

I went on.

"You know, when you write a daily and talk about risk as much as I do, people confuse you with some sort of radical perma-bear. But Merrill Lynch never hired me in 2000 with a bull on my business card because I was some radical perma-bear. Nor did a high-net-worth wealth management firm like Gluskin Sheff hire me just over three years ago because I am some radical perma-bear. I made my name by building a skill-set that takes the economic data points and connects the dots to what clients in this business need from a market economist, which is a cogent and thoughtful investment strategy."

"But yes, we are in the business of risk. When interest rates are near 0% as they currently are, the money market is telling you something about risk (that it is high) and about the economic outlook (fragile). So we have an enormous task in terms of identifying the risk, assessing the risk, managing the risk and then pricing the risk. At all times, we must ensure that our clients are getting paid adequately to take on the risks involved across all of our portfolios. The fact that we invest in the same strategies as our clients makes us sharpen our focus that much more since seeing our clients do well means we are feeding our families at the same time."

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“When Ira Gluskin and Gerry Sheff started the business back in the early 1980s, we were at the early stages of one of the most pronounced secular bull markets ever recorded. The first of the boomers were in their early 30s and heading into their prime risk-taking years. The first of the boomers are now in their mid-60s and have a reduced tolerance for risk. And the money market at the time, 180 degrees different than what it is flashing today, was signalling a prolonged period of corporate pricing power and prosperity. Double-digit short-term rates back then meant that any portfolio manager had a huge hurdle to clear. Then again, the level of the interest rate was also telling something about the level of economic growth that lay ahead. So a blessing and a curse at the same time. Today, 0% money market rates means we are playing from the white tees, but at the same time, the curse lies in the economic message of debt deflation and, as such, a very narrow fairway. Back in the early 1980s, Ira more often swung for the fences and for years hit many home runs — not that there wasn’t the odd strikeout. And Ira, who recently turned 70 but looks ten years younger, was hugely successful, especially in those early years.”

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“So I suppose what has changed the most in terms of the investment philosophy that has permeated many of our strategies since the early days is that we are no longer going to focus primarily on hitting home runs. Not that we don’t have power hitters in the lineup that can hit the ball out of the park — we have strategies on the bench that can indeed hit for power. But moving them up in the batting order will hinge on the market and macro environment and much more clarity over the outlook for the global economy — and signs that policy stimulus is starting to gain traction. So far this has proven elusive. Two rounds of QE and two rounds of Operation Twists and the broad market averages have been merely range-bound and the U.S. economy has re-entered a stall-speed bump for the third time in three post-recession years, which is beyond the realm of normality. We are going to focus on hitting singles and getting on base all the time. Hit singles when the market hits home runs (part of 2009 and 2010) and hit singles when the market strikes out (2011 and a decent chunk of this year, at least since April). To be sure, at some point, when the vagaries of a post-bubble credit collapse stop throwing nasty sliders at the marketplace and we get into a real hitter’s count of three balls and one strike, we will not be shy about bringing out the power hitters. But understanding the environment we are in and actively engaging the markets and what they give us is the key to successful investing and that is the case all the time. With risk-free rates at or near 0%, this is no time to run and hide in the dugout. At the same time, it is about ensuring that we are sending the right batters to the plate, in the right order, to face a left-hander with an unpredictable knuckleball.”

“So if there is a criticism, it is that we focus intensively on capital preservation. But there is an addendum to that, which is the preservation of cash flows as well. This requires a complete set of skills to match the market opportunities that are being presented to us. With that in mind, in a deflationary environment where rates are at or near 0%, it is not that “cash is king” as much as “cash flow” is king. Income. Safety and Income at a Reasonable Price or otherwise known as S.I.R.P. — many of our portfolios fit that bill. The other two D’s, in

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addition to deflation, that I have discussed in detail in the past — deleveraging and demographics — make the income theme that much more compelling. At some point — likely in the next secular bull market, which could still be years away, the income theme will grow stale and we shall see a return to aggressive growth and capital appreciation strategies. For now, it is important to have exposure to income-generating strategies within the equity market or the alternatives space and collect an economic rent as we wait for the inevitable transition to the next up-cycle."

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I kept going.

"I've been at Gluskin Sheff now for three years and I get asked the question still as to what the big difference is between being an economist on the "sell side" at large shops like a Merrill Lynch or a BMO Nesbitt Burns before that, and the life of an economist on the "buy side" at a wealth management boutique."

"Well, there are plenty of differences but the most important is this. First, in my previous life at a large sell-side bank, I flew all over the world seeing all the portfolio managers. But I would be in a large boardroom in a larger building and give my spiel in front of countless PMs and analysts, and then leave for the next meeting at some other building, then another and then off to the airport to go to another city and do the same thing all over again. Lather. Rinse. Repeat. But now, the only portfolio managers I speak to are our portfolio managers. And it is 24-7. My office is right beside Ira's and diagonal to our Chief Investment Officer, Bill Webb. I am sitting right out there in the trenches with the investment team, which is light years apart from being part of a research department on a different floor and often in a different building from the decision makers at a big bank."

"The questions I used to field in the old days, mostly from traders and the sales force were always "Dave, what's your call on this? … Dave, what's your call on that? In my current role at Gluskin Sheff, the questions I field from our portfolio managers are quite a bit different. I'll get asked "what's your base-case scenario on this?". Now keep in mind that I forecast a lot of variables. And only the most arrogant fool rules anything out, but you have to have a base-case forecast — the most likely scenario for X, Y and Z. But the question does not stop at "what's the base case?". But the portfolio managers constantly ask "and how much conviction do you have in your base case?". And the next question after that is "and what is the next base case after that, and what is your level of conviction on that … and the next base case after that?" and so on and so forth. It's a polite way of asking "where could you be wrong in the base-case forecast", and beyond that "where could you be wrong on the second most likely scenario" … this process extends right through the entire range of probable and possible outcomes."

"So I finally figured out what actually makes a portfolio manager tick! It took some time working on the investment floor but I did figure out the lens through which they look at the world. It is all about the distribution curve probabilities of

various outcomes and the potential reward of being right across the spectrum of outcomes benchmarked against the maximum cost of being wrong. It is all about "expected values" across the entire probability curve. And being able to identify various scenarios and attach probabilities of them happening and costing out the possible losses against the potential returns from being right and weighting them across the entire distribution curve … well, that, my friends, is the holy grail in terms of strategic investing. And in terms of my own professional development, all this goes to show that even for a 50-something like myself, an old dog can still learn some new tricks in this dynamic business of wealth management. What the portfolio managers have taught me the most is how to manage mistakes and learn from them and to spend time thinking about where my calls can go awry. Knowing how to manage one's mistakes is what makes the difference between a great and an average economist, strategist or portfolio manager."

"All that said, the key for all of us is to understand that we are still in the throes of a debt deleveraging cycle that first engulfed the housing and consumer sectors and is now attacking the government sector in country after country. It is not only Europe. China and the U.S.A. too. There is still far too much debt at all levels of society relative to the world's capacity to service it. This is a critical reason why government and central bank policies aimed at fighting traditional recessions in the past have so far been ineffective and now we have monetary authorities dipping into the toolbox of unconventional balance sheet expansions and contortions. We have governments battling a debt deleveraging cycle of epic proportions, and by definition, these phases involve debt paydowns, defaults and rising savings rates — a highly deflationary brew. And it also means that we now reside in a world of fat-tail distribution risks, where the range of outcomes is unusually wide, as opposed to the comfort zone of a classic post-WWII cycle, where we understood what caused recessions and we knew exactly what it took to get out of them, and where there was a much thinner tail to the probability curve."

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"May those days rest in peace. But once we can acknowledge that we are in a fat-tail world, it is akin to moving into the acceptance phase of the classic five Kubler-Ross stages of grief. This is no time for denial. And once we have made this determination, one can then reasonably construct a prudent investment strategy that involves exposure to hedge funds that really hedge the risks, exposure to asset classes that are at least halfway priced for a recessionary outcome like corporate credit, and exposure to income-generating assets of all types, including hybrid portfolios with low betas, low but rising payout ratios in companies with strong balance sheets and a history of generating stable cash flows."

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Gluskin Sheff at a Glance

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OVERVIEW

As of March 31, 2012, the Firm managed assets of $5.5 billion.

Gluskin Sheff became a publicly traded corporation on the Toronto Stock Exchange (symbol: GS) in May 2006 and remains 46% owned by its senior management and employees. We have public company accountability and governance with a private company commitment to innovation and service.

Our investment interests are directly aligned with those of our clients, as Gluskin Sheff's management and employees are collectively the largest client of the Firm's investment portfolios.

We offer a diverse platform of investment strategies, including Canadian, U.S. and International Equity strategies, Alternative strategies and Fixed Income strategies.[1]

The minimum investment required to establish a client relationship with the Firm is $3 million.

PERFORMANCE

$1 million invested in our Canadian Equity Portfolio in 1991 (its inception date) would have grown to $9.3 million[2] on March 31, 2012 versus $6.2 million for the S&P/TSX Total Return Index over the same period.

$1 million USD invested in our U.S. Equity Portfolio in 1986 (its inception date) would have grown to $14.5 million USD[2] on March 31, 2012 versus $12.2 million USD for the S&P 500 Total Return Index over the same period.

INVESTMENT STRATEGY & TEAM

We have strong and stable portfolio management, research and client service teams with "best in class" talent at all levels.

We have a strong history of insightful bottom-up security selection based on fundamental analysis.

For long equities, we look for companies with a history of long-term growth and stability, a proven track record, shareholder-minded management and a share price below our estimate of intrinsic value. We look for the opposite in equities that we sell short.

For corporate bonds, we look for issuers with a margin of safety for the payment of interest and principal, and yields which are attractive relative to the assessed credit risks involved.

We assemble concentrated portfolios - our top ten holdings typically represent between 25% to 45% of a portfolio. In this way, clients benefit from the ideas in which we have the highest conviction.

Our success has often been linked to our long history of investing in under-followed and under-appreciated small and mid cap companies both in Canada and the U.S.

PORTFOLIO CONSTRUCTION

In terms of asset mix and portfolio construction, we offer a unique marriage between our bottom-up security-specific fundamental analysis and our top-down macroeconomic view.

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For further information, please contact questions@gluskinsheff.com

Notes:
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2. *Returns are based on the composite of segregated Canadian Equity and U.S. Equity portfolios, as applicable, and are presented net of fees and expenses.*

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