June 24, 2016

FGP's views on the Brexit

As you have undoubtedly heard by now, the Brexit vote count concluded early this morning. In what was an unexpected outcome, the United Kingdom voted in principle to leave the European Union. While we thought that voters would opt to remain part of the EU, it is clear that the majority of the population has spoken out against the status quo.

It is always very difficult to predict the outcome of these decisions and the magnitude of their effect on markets. However, today we are witnessing the early impact on equity and bond markets. As one would expect, markets are reacting negatively. The conventional wisdom seems to be playing out in the form of a flight to safety, where stocks are being sold off to buy bonds.

While the magnitude of this decision is both material and frankly unprecedented, we have experienced other notable events in the past. Whether it is the 2008-2009 credit crisis or a certain October day in 1987 (Black Monday), the world has always had "events" that triggered short-term equity market sell offs. We also know that being a seller in these situations, and chasing the safety of cash, could potentially miss the recovery.

Foyston, Gordon & Payne Inc. (FGP) buys securities at a discount to their intrinsic value to provide a margin of safety to investors. Regardless of the event, whether it was foreseen or unexpected, the prudent investor follows a prudent time-tested strategy:

- Invest in high quality companies that have long-term track records and good balance sheets
- Build diversified portfolios
- Follow a consistent, disciplined investment approach (during good and bad times)

With respect to the first point, we believe fundamentally at FGP that our investment portfolios are built on high quality companies that can endure short-term macro events. In fact, many of our companies have withstood the proverbial test of time. Consider companies like the Bank of Nova Scotia (incorporated in 1832), Canadian Tire (first store opened in 1934) or Imperial Oil (incorporated in 1880). Or consider some of our international holdings, like Verizon Communications (which started as Bell Atlantic in 1984), Emerson Electric (started in 1890 in St. Louis Missouri), or Zurich Insurance (founded in 1872 in Switzerland). They were founded a long time ago, and they are here today. This is Resilience.

The next step of course is to assemble a group of high quality investments that offer diversification. As you know, FGP aims to build diversified portfolios that look meaningfully different from the index. You can never aspire to beat an index if you look like the index. We pay close attention to building portfolios with companies that are fundamentally strong on an individual basis, but also are diversified across different types of businesses and that benefit from different business drivers.

For instance, we have positions in Loblaws (a domestic grocer), Fairfax (an insurance company with global operations) and SNC Lavalin (an engineering company with a big ownership stake in the 407 toll highway in suburban Toronto). These companies represent very different businesses, from the perspective of revenue sources (fully domestic vs. international) and sensitivity to business cycle (steady vs. cyclical), interest rates and equity market movements.

The last step, and the one that requires incredible discipline, is to maintain a consistent and methodical investment approach, regardless of the "pessimism" or "euphoria" in the market. It's easy to think good times will last forever. Similarly, when times are incredibly pessimistic, it's easy to focus on the events of a single day, losing sight of the long-term.

The success of an investor's reaction depends on the consistent application of his or her investment philosophy. While many investors are, no doubt, feeling the lure of the herd mentality to "sell" on this bad news event, we will look very prudently for opportunities that emerge from the unfolding events. When companies sell off materially, it's our job to determine whether the market is fairly or unduly penalizing a company's valuation. It's our job to know the intrinsic value of these companies and look beyond the noise to find where the true "bargains" lie.

As I compose this letter, our team is getting ready to find those deals that may emerge. For example, we own a position in Britvic, a British beverage manufacturer and distributor. The company generates about two-thirds of its revenues in the U.K. and the remaining third internationally. (They sell their products to 50 countries globally.) Due to the company's diversification, we believe they have some natural business hedges or built-in revenue diversifiers, such as operations in the U.K., Ireland, France, and now Brazil, that protect their business regardless of how the Brexit fallout unfolds. While the U.K. decision will undoubtedly change the way they conduct business, we are optimistic that consumers will continue to consume their products.

Many market commentaries will be issued in the coming days and weeks that will profess to “know the future” and espouse the implications of the Brexit. We believe that it will take some time to truly understand the extent of this decision and we don’t anticipate making any major changes immediately. Our Investment Committee will be reassessing our asset mix positioning over the Brexit decision.

While one never wants to wake up to an event like the one that is unfolding, we assure you that we will continue our research and due diligence on the present and unfolding impacts of the Brexit event and continue to communicate our findings and strategy in a timely manner.

If you would like to discuss these issues, please do not hesitate to contact me or your client service team.

Sincerely,

Bryan Pilsworth, CFA, MBA
President & Portfolio Manager – Canadian Equities

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