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## Happy Halloween

*"There are mysteries which men can only guess at, which age by age they may solve only in part."*

*- Bram Stoker, Dracula*

In the above quote, Bram Stoker's vampire hunting Professor Van Helsing was asking permission to desecrate a grave. We could use the same phrase to convey our lack of confidence when trying to predict short-term market mysteries. When it comes to Halloween, be afraid of ghouls and ghosts; when it comes to investing, be afraid of the overly confident.

When I taught Security Analysis & Investing to university undergraduates, I tried to communicate the risks associated with overconfidence. Class demographics were skewed toward young adult males. Psychological research demonstrates that in areas of finance, men are often more overconfident than women. In a Berkley study conducted by Brad M. Barber and Terrance Odean that assessed discount brokerage accounts for over 35,000 households, they found that men traded 45% more than women. This excess trading unnecessarily dragged down net returns.

In investing, overconfidence is like eating candy. A little bit here or there may not be an issue, but too much is sickening. Confidence comes in cycles, it feeds off recent success. Perhaps the best current example of this in Canadian equity markets is Valeant. The company went on a debt fuelled acquisition spree, and in a short period piled up more debt than any other non-financial public company in Canada outside of the major pipelines. Revenue and adjusted earnings were growing at a rapid pace and the shares were climbing. What was not to like? Equity investors piled in and it seemed with each acquisition, judging by valuation measures, investors gained more and more confidence. The forward P/E multiple for the stock ballooned from less than 12x earnings in mid-2012 to nearly 20x this past summer while debt levels grew by more than $20 billion. For a short period, it became Canada's largest public company. Now, with US prosecutors subpoenaing the company, seeking information on drug-pricing decisions and short sellers questioning sales practices, investors are quickly running for the exit. Shares have dropped over fifty percent in less than three months.

In trying to reduce the risks associated with overconfidence in our investing, we believe framework and fear are important considerations. From a framework perspective, we need to be comfortable owning businesses not only when a share price is climbing but also when they are in decline. We do not own Valeant because its business model, balance sheet, and compensation are all simply too aggressive for us to be comfortable with. The company does not fit our investing framework.

*"Be wary then; best safety lies in fear."*

*- Shakespeare, Hamlet*

Fear also keeps confidence in check. A successful investor must be open to the possibility of being wrong, candidly identifying mistakes and learning from them.

One other company that recently came under attack by a short report is DH Corporation. Similar to Valeant, the shares came under significant pressure upon release of the report, plummeting over 15%. Although we do not own shares in DH Corporation, we do own their bonds in some fixed income mandates. The business has also been an aggressive acquirer, as it transitions from a traditional paper based cheque supplier to providing more software driven financial service solutions.

Whether or not the short seller is correct in their assertions, we believe these bonds remain a sound investment opportunity. DH has a diverse customer base, numerous cash flow streams, a lack of capital intensity and improving credit metrics that should remain healthy throughout the bond's 4.9-year life. We will continue to assess our thesis; if the facts change, we will be required to take action.

Although we have built an investment philosophy around risk management, we are also open to the opportunities fear creates. In essence, we must separate the tricks from the treats while aiming to avoid misplaced confidence or fear. Enjoy some Halloween candy this weekend, but of course, not too much.