

DEEP-VALUE REPORT

Mackenzie
CUNDILL FUNDS

Share buybacks, takeovers and the search for value

Thompson: “We’re using every trick in the book to find and uncover value.”



In March, when the markets found a bottom in the steepest correction since the Great Depression, value investing was redefined – at least temporarily. In the past, managers at Mackenzie Cundill Investment Management often spent their time hunting for obscure stocks that were trading down, but with a story that might eventually send them higher. But earlier this year when the sell-off

seemed to be still gathering momentum, valuations on some of the biggest brands in the corporate elite – names like Dell, Microsoft and FedEx fell to levels once reserved for broken companies, and were quickly added to the Mackenzie Cundill Value Fund.

Now, six months later, the market has righted itself with the S&P 500 up more than 50% from its March low. That’s the good news. The bad news, says Cundill Value Fund Manager Jim Thompson, is that many of the companies that were added to the fund earlier this year, have risen sharply and are again approaching his estimate of fair value. That means the Cundill investment team will again have to drill down in search of unloved companies that many investors have never heard of. “We think the days of being able to find large companies like FedEx trading at book value are over for now,” says Thompson, who is also Senior Vice-President and Investment Team Lead at Mackenzie Cundill Investments. “We’re going to have to work harder to invest the same kind of money we did six months ago.”

That hard work includes monitoring mergers and acquisition (M&A) activity and corporate and executive share buybacks – a possible sign, says Thompson, that management believes their company is trading at a discount, making it a potential candidate for the Cundill Value Fund. “We’re simply using every trick we know to find and uncover value,” explains Thompson. “We’re going back to the way things have historically been done.”

Looking back, market historians may conclude that the March 2009 low was an historic buying opportunity. Dell, to name just one company in the Cundill Value Fund that has rebounded, is up 40% on the year. And FedEx at the time of writing was bumping up against its 52-week high. That’s a far cry from earlier this year when companies were being added to the fund at 50 to 60 cents on the dollar – in other words they were being bought at almost a 50% discount to what the managers calculated their real value to be. But with the market run-up, that discount has closed, with holdings trading closer to 85 cents on the dollar. Adds Thompson: “A lot of the stuff that was trading with yawning discounts are gone – those discounts closed very rapidly.”

On the plus side, Thompson says the snapback rally in the Cundill Value Fund’s blue-chip lineup has allowed him to turn a profit in a relatively short period of time. Typically, owning lesser-known deep-value is a game of patience, with it taking months or even years to realize gains.

Still, Thompson hasn’t started to sell into the rally. He’s held back because he says it’s difficult to get a true reading on where corporate profits are headed, which will determine how much upside is left in many of the Cundill Value Fund’s prominent names. And Thompson says the market’s strong run-up seems to suggest that corporate profits will recover. “I’m worried that with a little bit of recovery and inventory building they could surprise to the upside,” says Thompson. “So I want to make sure that we revalue our names very carefully to make sure we don’t sell prematurely.”

For example, even though Dell is up 40% on the year, Thompson says it’s still reasonably attractive when you combine the amount of cash they’re carrying on the balance sheet with their ability to generate revenue. They’ve also made some acquisitions, and Thompson believes the company will earn about \$1 a share this year and a \$1.35 a share once a recovery is clearly underway. “Their major customers are businesses,” says Thompson. “So we’re hopeful that with any kind of revenue growth they can do even better than they are right now.”

Continued



Traditionally, Cundill Value Fund managers have not invested in companies that are based in emerging markets. Often, EM companies have not been around long enough to gauge on a value basis. But the lines between developed and some emerging economies are blurring, particularly in the BRIC countries: Brazil, Russia, India and China. Thompson says the Cundill investment team is now looking at a number of Chinese companies, but stresses that it is early days yet. “There are a number of companies in Hong Kong that have been around for quite some time,” adds Thompson. “We’ve also been doing some work on companies in India. So we’re trying to push our resources that way.”

While the Cundill team continues to analyze the earnings outlook, they are also monitoring M&A activity, and its potential to boost shareholder returns. When it comes to M&As, Thompson breaks management into two groups: those who will do anything to keep their salary by maintaining the status quo, and others (often holding large share positions) who will put their company into play. “I have a 10-to-1 theory,” explains Thompson. “If management holds 10 times their salary in stock, it tends to swing the balance toward selling. So if you’re

a 50-year-old executive and can walk away with \$150 million, you don’t need to build an empire to protect your salary.”

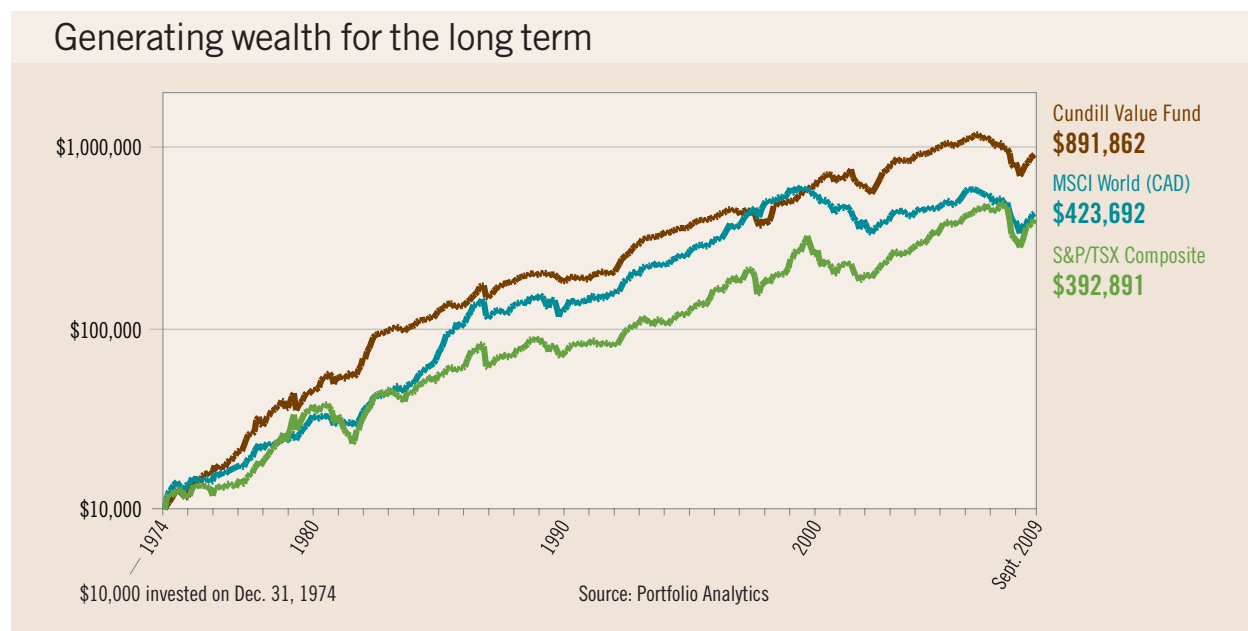
If there is a candidate that will benefit from M&A activity in the Cundill Value Fund it could be Liberty Media. It controls a basket of coveted assets including The DirecTV Group, with 18 million satellite subscribers. “There is a high likelihood of a merger, and almost every week there’s a story about whether AT&T or Verizon is going to buy DirecTV,” explains Thompson. “I’m not saying that it’s going to happen, but the value of DirecTV could be somewhat higher to an acquirer.”

Thompson is also looking at corporate share buybacks as a way to maximize shareholder value. He analyzes buybacks in two ways. First, he attempts to determine whether a company has enough discretionary cash flow to maintain its competitive position. If it does, he then analyzes what the company will do with the surplus cash flow. “In our case we’re looking for undervalued companies,” says Thompson. “Now, if the stock is trading at 60% of net asset value, then it is very difficult for a company to have a more rational use of money than to buy back shares.” And in the process, attract the attention of the Cundill investment team.

Mackenzie Cundill Value Fund

Thirty-five years later and still growing

It’s 1975 and the Altair, the first home computer is launched, Jaws is the top-grossing movie, the Vietnam War effectively ends and Peter Cundill begins running the Cundill Value Fund. The fund would thrive over the next 35 years, incurring only five down years along the way by investing solely in companies trading at a steep discount to what the Cundill managers believe their real value to be. It’s a strategy that continues to work, with the Cundill Value Fund perennially ranked as one of the top global equity funds.



Finding value in conglomerates

Tiley: “We often find that the underlying assets are cheap.”

In September, Keystone Cundill International Value Class was merged into Mackenzie Cundill International Class. The fund, managed by George Morgan and co-managed by David Tiley, has a mandate to invest anywhere in the world outside of North America. Below, Tiley discusses their approach to investing and some recent additions to the fund.

What’s your immediate goal for the fund?

It has Cundill in the title so we’re looking for companies trading at a steep discount to their net asset value (NAV). And we want to increase the discount to NAV in the fund by adding cheaper names. Even though the market has had a strong rally, George Morgan and I each have a bag of ideas that can help get us there.

How did you play the rally off the March bottom?

We started adding names in March when the rally began. We took the opportunity to beef up our European holdings with names we hold in other parts of the overall Cundill portfolio. We have a strong conviction in them.

You’ve invested in a number of conglomerates. Why do you like them?

We often find that the underlying assets are cheap. And when things turn around, earnings improve and more cash is streamed up to the holding company. It’s a virtuous circle.

Exor is an Italian conglomerate. How’s that working out?

Exor was created when the Agnelli, the first family of Italian business, merged two of their holding companies. The stock has doubled, in part because Fiat, Exor’s key asset, was given the keys to Chrysler without putting down any of its own cash.

Alba SpA of Spain is another conglomerate you’ve added.

Alba is a top-tier investment company that is very focused on investment returns. The key holding, ACS, is an engineering firm with subsidiaries that operate toll roads and airports. It has also invested in solar and wind energy, and is now one of the largest producers in Spain. When we bought it, it was trading at a 50% discount to NAV.

Let’s look at Deutsche Post and a couple of recent additions to the fund.

Deutsche Post controls 90% of the German market and also owns DHL, the international courier. The shares were down primarily because DHL was hemorrhaging market share in the US. But management decided to get out of the ground business in the US, which was an enormous cost saving. They also have a new CFO with a turnaround track record, and the company should have significant pickup in the global recovery.

Deutsche Telekom is another German company in the fund.

As credit markets thawed, investors jumped back into riskier names. Others like telecoms that are defensive with strong balance sheets, have underperformed. That gave us a chance to add a name like Deutsche Telekom, which is very, very cheap with a huge yield.

You’re also investing with Australian billionaire Kerry Stokes.

Seven Network is Stokes’ investment vehicle. He’s generated double-digit returns every year for the last 25 years. Lately, he’s been buying shares in Australia’s number one satellite TV operation. He’s still sitting on a big pile of cash, and he’s starting to buy more assets in the pay-TV sector that we think are attractively undervalued. With his track record, shareholders stand to make a lot of money.

The fund’s holdings in Asia have been increasing.

We have a stake in China Telecom, HSBC Group and Cheung Kong Holdings, which is controlled by Hong Kong billionaire Li Ka-Shing. It controls a number of trophy assets in Hong Kong, including ports, terminals and telecom companies. He’s someone who has a superior record when it comes to buying and selling assets, and he’s extremely well connected in mainland China.



Deep-value analysis and Parmalat. More milk and yogurt, or a takeover?

Most Canadians probably know Parmalat for the milk products it sells across the country. But David Tiley, Co-Manager, Mackenzie Cundill International Class, likes Parmalat, an Italian multinational operating in 13 countries, for another reason: “We bought Parmalat because the cash on the balance sheet was fortress-like, amounting to more than half the market cap.”

In addition to its cash-rich balance sheet, when it was purchased for the fund, Parmalat was trading at a deep discount to its global peers and new management was coming in. But the problem with milk, explains Tiley, is that it’s heavily commoditized and regulated, leaving firms without a lot of pricing power. So when the Cundill Investment team met with management they encouraged them to improve the product mix by introducing more value-added products like yogurt, juice and lactose-free drinks.

While urging the company to boost revenues with a revamped product line, Tiley also thinks the shares could get a lift from a potential takeover. He argues that as credit markets continue to thaw, Parmalat’s cash hoard and market share would be attractive to a company like Paris-based Danone, another seller of dairy products worldwide, but with a gaping hole in its Italian portfolio. As well, private equity firms, like the Blackstone Group, which have been hunkered down since the financial crisis, are starting to stir again. Says Tiley: “A company like Parmalat, that is sitting on a pile of cash would be a slam dunk to be taken over by a company like Blackstone.”

The ten pillars of Cundill investing

1. Strict adherence to the deep value style of investing – stocks must be cheap when compared to assets
2. Increase diversification and lower risk by investing globally
3. Business risk is more important than market volatility
4. Holding cash is not tactical, but rises and falls with the availability of value opportunities
5. Stocks are often held for three to five years
6. There is no attempt to time the markets
7. Funds do not mirror the portfolio weightings of major benchmarks such as MSCI World Index
8. Portfolios are generally concentrated in 25 to 30 stocks
9. Funds are hedged against currency risk as a matter of strategy where it is economically reasonable to do so
10. Stocks usually carry a dividend, which in effect pays investors to wait for a stock to rebound

For more information on the **Mackenzie Cundill Value Fund** and **Mackenzie Cundill International Class** please go to www.mackenziefinancial.com/cundill

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