



Forward thinking. Finding value.

Blog Post: Capital Preservation and Probabilities

We've been asked a lot over the past week about whether or not we have exposure to certain headline housing stocks in our equity portfolios. Fortunately, the answer is no. We think this is a good opportunity to highlight some of the key aspects of our investment strategy and why we shied away from stocks in the non-prime housing market.

First, from a financial perspective, there was a lot to like in the sector. Many of these companies posted attractive returns on their equity, grew at high rates while maintaining low loan losses. At the right price, such a combination of attractive fundamentals tends to pique our interest. But when investing, it is also important to keep in mind that just about everything is cyclical to some degree. Thus, the second part of our analysis was to take a step back and assess whether the industry was at the beginning, middle or end of its respective cycle. The Canadian real estate market has appreciated significantly since the early 2000s, home ownership is at, or near, all-time highs, and affordability is questionable given the lower real income growth in Canada over this period of time. These factors led us to believe we were in the late innings of the game.

We don't pretend to know when bubbles are forming or when they might burst. And we were not actively seeking to "short" the housing market. When we stepped back and looked at the industry from a probabilistic perspective, we could certainly see some scenarios where the prevailing bullish trends might continue. But we could also envision many potential scenarios where the market might be due for a decline. As the cycle became increasingly extended over time, we felt risks were growing because the inevitable turning of the cycle was drawing closer with potentially negative outcomes for investors.

In our office, we say that there are only two types of companies in the market: Companies that are *having* problems and companies that are *going to have* problems. History may not repeat exactly, but patterns do emerge that are worth keeping in mind. We still recall the dreadful experience of many Americans following the peak of their own overheated residential real estate market a decade ago. Numerous housing-focused companies quickly went from *going to have* problems to *having* problems. In many cases, the equity of those companies was wiped out in the process. It was the subprime real estate market in the US that was the first to crack (and now it appears the same could be the case in Canada.) As such, our decision was to steer clear of the Canadian subprime sector entirely – it was in our "too hard" pile!

For several years we've watched developments from the sidelines as many of these stocks continued to climb higher. It was hard not to be somewhat envious! Today, we are pleased that we positioned our portfolios to avoid the potential losses. As we've noted in the past, one of our primary goals is capital preservation and we think this is a good illustrative example of this process in action.

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