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Have Your Cake and Eat It Too Investing

** SPECIAL UPDATE **

The Importance of the Vital Few (Updated)

March 15th, 2016

Sometimes markets give us a gift. That gift is the chance to learn something important from the behavior of an investment, and apply that knowledge to future investment decisions to your benefit.

There have been fewer better or more timely examples of this than the huge price move in Valeant Pharmaceuticals (symbol VRX) over the last few years. You may remember we wrote about Valeant being one of the 'good' vital few in August of 2015. At the time Valeant was an investment in both our Canadian Growth Portfolio and North American Growth Portfolio and was one of our top performers.

Shortly after our article was published, Valeant and the Pharmaceutical sector as a whole was hit by an avalanche of negative news (see "Pharma Bro and Hillary Clinton"). Valeant fell by about 35% in the last 3 weeks of September.

Faced with imperfect knowledge of how this would all unfold in the future (rebound, further decline, both, etc…) we simply followed our rules and sold Valeant (around $240) in both portfolios.

It is with no small sense of irony that the "Vital Few" article we penned positioned Valeant as a 'Vital Few' winner, a mere 4 weeks before it was sold based on the fact it was beginning to behave as a 'Vital Few' loser.

Fast-forward five months and Valeant trades just under $50 today.

There are so many practical, useful investment tips that can be gleaned from this story that we thought we would update our old Vital Few article with what we hope are the more relevant points:

- Your best performing stock can quickly turn into your worst performing stock; we pay attention to what the market is telling us and we know when to sell.
- Never fall in love with an investment based on its past performance, or how much money it has made you (especially if it's just a paper gain).
- Avoid price anchoring at recent highs or lows; if the trend has turned down, we sell it immediately once we recognize this new reality. Waiting to sell at last week's (or month's) price high almost always leads to paralysis by analysis and getting trapped in the subsequent price collapse.
- Never buy into an investment undergoing a rapid price decline. Others may try to persuade you otherwise, but it is not their money you're going to lose if they're wrong.
- Never average down. When you average down on a position you've already lost money on you're increasing the magnitude of the loss if the trend continues and strengthening your emotional commitment to 'being right' on the trade. The best course of action is to cut losses short and keep them manageable and recoverable.

Conclusion: We don't know what the future holds for Valeant any better than anyone else. Maybe it has bottomed here at $50. Maybe it's going to zero. We do know, however, that until the odds favor owning it we will be avoiding it and looking elsewhere. So far so good!

The original Vital Few article follows and the original can be found on our website. Please call us if you have any questions.

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Have Your Cake and Eat It Too Investing

The Importance of the Vital Few

By Jeff Woods

August 20, 2015

There is an important principle in investing called the 80/20 rule, otherwise known as Pareto's Principle (or the law of the vital few). The 80/20 rule is not an exact ratio – it can be 70/30 or 90/10. But the premise is the same – roughly 80% of the results come from 20% of the participants. In investing, it means a large share of the growth will be generated by only a few positions in the portfolio (the vital few). This is true of losses too. The bulk of the portfolio losses will be generated by a small number of big losers (the vital few you wish you didn't own). And the balance, the remaining 60%, will likely produce a negligible gain or loss.

Given this rule, then you can see why we advocate regularly reviewing all the positions within the portfolio and selling those that start to underperform. Not every underperformer is sure to turn into next year's 'disaster stock' – but we can be sure that *every* disaster stock we have ever owned started out as a consistent underperformer.

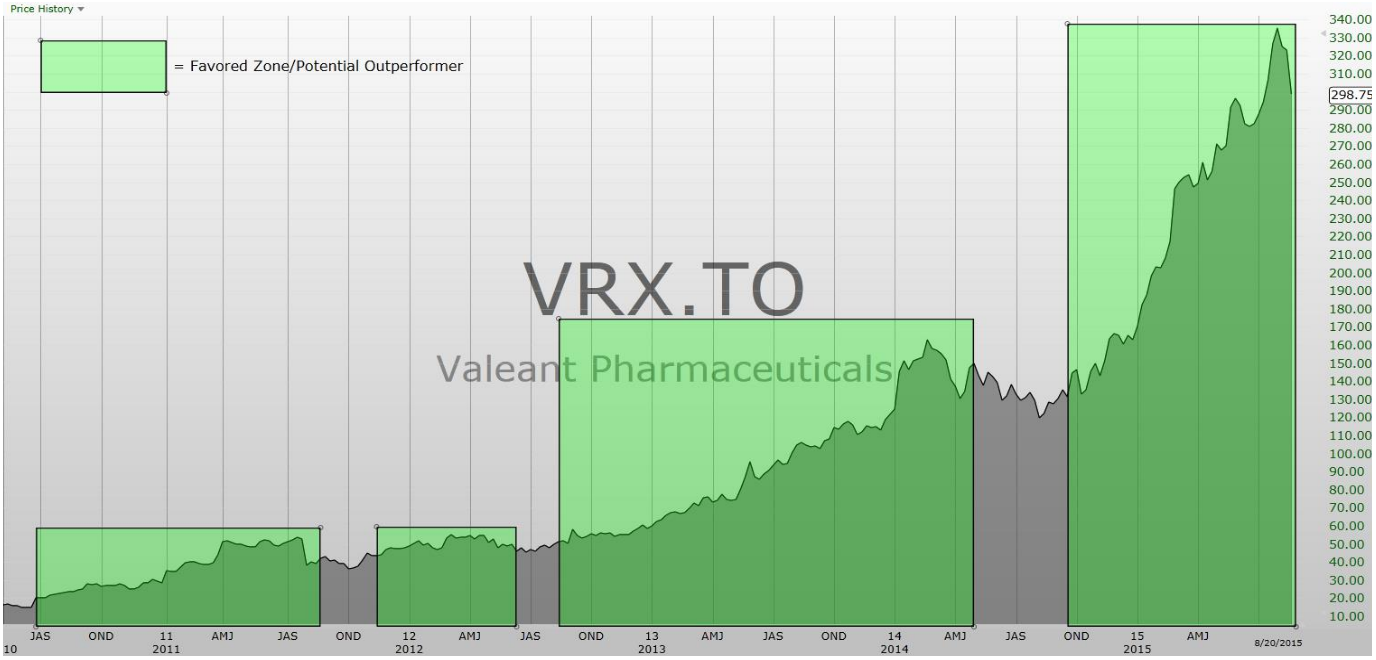
We were told early on in our careers to 'be patient' when investing. We would offer more useful advice - 'Be *patient* with your winners; be extremely *impatient* with your losers.' If we can identify which stocks have the potential to become members of the 'worst 20%' club, they can be sold before that possibility turns into an uncomfortable reality.

The following are two stocks we have owned this year in our discretionary portfolios; they are prime examples of the 80/20 principle at work.

80/20 Rule Winner – Valeant Pharmaceuticals (VRX)

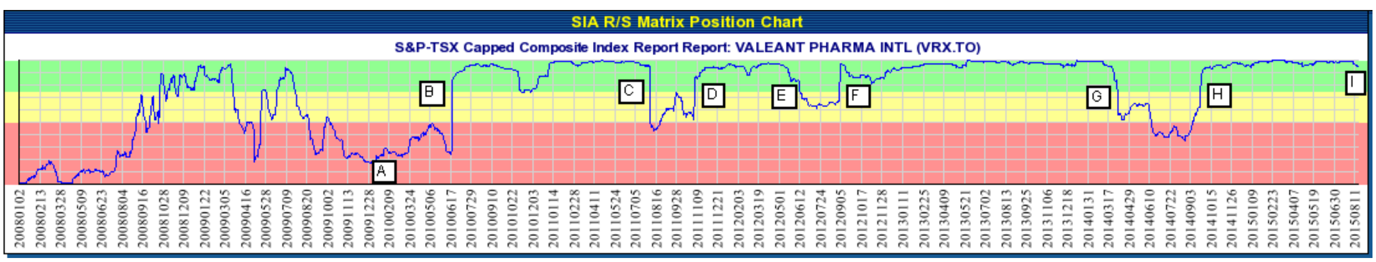
Valeant is a great example of how one good outperforming investment can contribute a large part of the overall portfolio returns. Valeant has contributed +4.2% to the return in our Canadian Growth Portfolio this year. With Valeant, we are beating our benchmark (the TSX Composite Index) by +7.0% YTD. Without it, the other 19 stocks in the portfolio have only contributed enough growth to be ahead of our benchmark by +2.8% YTD. Valeant has been critical to our success this year, and is clearly in the 'vital few' camp.

We show the periods of time Valeant has qualified as a 'relative outperformer' based on our investment methodology. These periods of time are denoted by the green rectangles on the chart below; 3 out of 4 times it has proven to be part of the 'vital few'.



Since January 2010, Valeant has shown four periods of potential outperformance. Sometimes this outperformance comes in the form of a flat share price during a period of negative market returns. A good example of this is the period of time from November 4, 2011 to June 13, 2012 (the points marked D and E on the graph below). Even though VRX only achieved a +3.2% gain during this period, it still provided outperformance compared to the -7.9% loss experienced by the TSX Composite market index.

Here is a snapshot of our investment supply-demand tool at work with Valeant (the area in green implies a 'potential outperforming' stock, anything else is a sell):



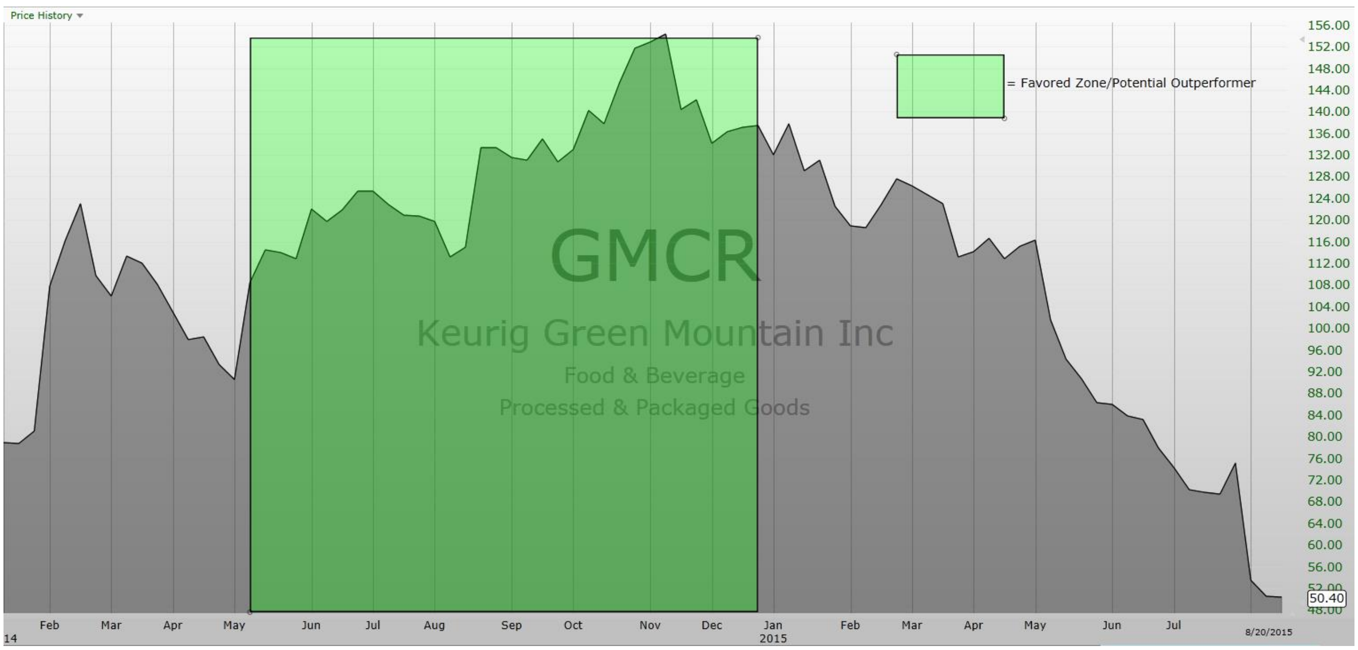
Reference	Date	Price	What happened
A	Jan 1, 2010	$15.31	Start date
B	Jun 22, 2010	$19.25	VRX enters Favored Zone (buy)
C	Aug 4, 2011	$40.20	VRX exits Favored Zone (sell)
D	Nov 4, 2011	$45.03	VRX enters Favored Zone (buy)
E	Jun 13, 2012	$46.45	VRX exits Favored Zone (sell)
F	Sep 4, 2012	$57.94	VRX enters Favored Zone (buy)
G	Apr 4, 2014	$137.00	VRX exits Favored Zone (sell)
H	Sep 25, 2014	$141.66	VRX enters Favored Zone (buy)
I	Aug 19, 2015	$320.72	Still in Favored Zone today (hold)

By following this investment philosophy Valeant has produced outsized gains for our investors, and year-to-date has earned its place as one of the 'vital few'.

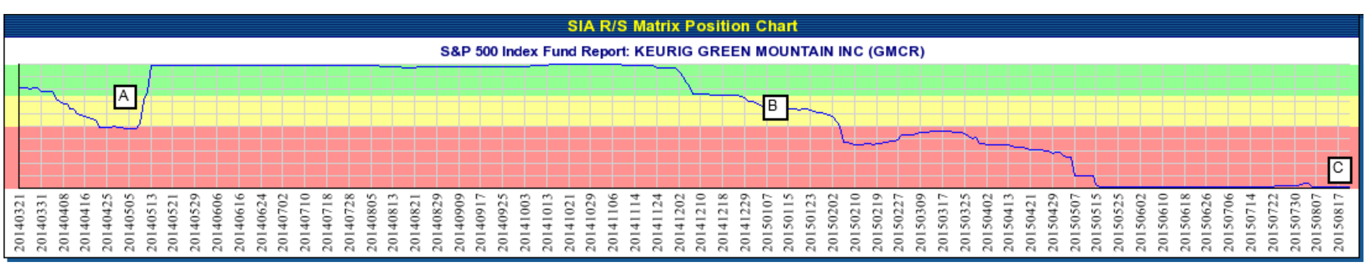
80/20 Rule Loser – Green Mountain Coffee Inc.

Green Mountain Coffee Inc (GMCR-US) is a great example of a 'vital few' stock you'd be glad you didn't own this year. Despite achieving stellar returns of +76% in 2014, by the end of the year it had started to show signs of persistent weakness relative to the market. We bought this stock at the inception of the North American Growth Portfolio on October 21st, 2014; at the time it was solidly in our favored zone and a potential outperformer.

By early January this year it had fallen out of the favored zone (see spot denoted by the 'B' on the second chart below) and was sold for a -5.2% loss. We are very, very happy to have taken that loss – GMCR is down over 61% year-to-date.



As we said earlier, the wrong kind of patience can seriously hurt your odds of investment success. Even in our well-diversified North American Growth Portfolio, Green Mountain Coffee Inc. would have reduced returns by about -2%. Applying a supply/demand filter (like the one shown below) to the securities in our investment portfolios gives us the confidence to know when we would be wiser to take a small loss (-5.2%) rather than risk a much more painful outcome (-61% year-to-date and counting).



Reference	Date	Price	What happened
A	May 12, 2014	$110.17	GMCR enters Favored Zone (buy)
B	Dec 27, 2014	$137.43	GMCR exits Favored Zone (sell)
C	Aug 20, 2015	$50.40	GMCR still out of favor (ignore)

The 'Vital Few' can make a big difference

Valeant Pharmaceuticals and Green Mountain Coffee Inc. are both good examples of the Pareto Principal at work. Big gains and big losses in individual stocks are a regular occurrence in equity markets. To make this principal work in your favor we are extremely patient with the stocks or investments that continue to outperform. Our process ensures we don't take profits too early. More importantly, we are extremely *impatient* with any underperforming investments and by applying our well-defined, objective sell discipline we limit large losses within the portfolio.

We will expand on this idea in future editions of 'Have Your Cake and Eat it Too Investing'.

Putting this approach to work for you

How can our 'Have Your Cake and Eat it Too' report benefit you?

1. Call us for a review of your current investment positions and how they stack up – are the odds of success in your favor, or not?
2. Follow along and keep learning. Sign up to receive future newsletters and research reports (contact information is listed below).
3. Call us to book a meeting and we can discuss whether our unique investment approach would be a fit for you.

Cautionary Note

This report does not constitute a recommendation or solicitation to buy or sell any investments mentioned in the article. At the time of writing we own shares of Valeant in both the Canadian Growth Portfolio and the North American Growth Portfolio. We may sell our position in VRX at any given point in time that our indicators dictate.

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