BRIAN PILSWORTH

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You joined FGP as a senior analyst covering technology, media, and telecom in 2007. How did the team react to the ensuing downturn in the market during the recession?

Well, I guess it was pretty traumatic. None of us had experienced anything quite like that. In 2007, things were starting to happen, but it wasn't quite the climax of the negativity, which really happened in September of 2008. In hindsight, you can piece things together. I do remember negative things happening in 2007. I remember that one of the European banks was trying to buy an American mortgage originator; every time they tried to buy, the price got a little lower and lower. It was a weird thing to see happening publicly. But in 2008, we had a British bank fail, which was Northern Rock. People were lining up, and there was a run on the bank. This was the first time I had seen a real run on a bank. I remember looking at the front cover of the Financial Times, and they were showing people lining up trying to get their money out. That was a warning sign that a lot bad things were going to happen in 2008, sort of a warm-up act.

Did you see it as an opportunity with everything so cheap around that time?

Well, things didn't get epically cheap, until March 2009. In 2008, by the end of the year, the TSX was down 33%, and our fund was down 31%. So, even though we did better than the market benchmark, we still experienced an incredible loss. It was difficult to become a buyer because the things that you owned had gone down so much, that you were thinking, "Do I want to take a risk in establishing a new position right at the height of when global banking system seems to be on the rocks?". So, we stuck to our guns and held a lot of our investments, in fact, most of our investments. We didn't start trading, so to speak, until 2009, and the bottom was March 2009, and after that 2009 was an epic year. There was more than 100% recovery.
I think the most important lesson is that you have to stay in the market because it was impossible to predict just how fast things would fall, and it is difficult to predict just how fast things would recover. But, if you got scared and nervous and sold all your stocks in December 2008, and you didn't put that money back in the market in 2009, that would have been a terrible mistake. So, we had to spend a lot of time cautioning our clients to stay with their portfolios and stay with their asset mix, and just be patient and trust that things would recover. We had our most trading in a long time in 2009; our portfolio turned quite a bit.

How does the research process work at your fund? Are ideas generated at all levels? Do analysts come up with ideas, or do portfolio managers?

Ideas can come from anyone; an analyst or a portfolio manager. No one knows every company intimately, so we encourage people to speak their mind and float ideas around. The starting point for ideas, and this is going to sound boring, is our portfolio. This is because theoretically all of the companies we own should be the best quality and value. So, for a hypothetical example, let's say we own BCE and Telus. BCE has gone up in value a lot, and Telus is really cheap. Let's sell down BCE and increase our weight in Telus. Occasionally, you look outside of the portfolio and say, maybe Rogers has been hurting, so maybe it's time to consider buying Rogers. In a normal year, we may buy one or two companies, and maybe sell one or two companies. In the past year, we haven't done any new buying or selling because the market has been very expensive.

Do you have a "dream list" or a working list of consideration of companies that you would buy?

Yes, we have a working list of all Canadian companies in the small cap space (anything with a market cap. below 250 million dollars), and in the large cap space. There are approximately 180 companies that have market caps above 2 billion dollars, right up to Royal Bank of Canada, which is just under 150 billion dollars. Of those 180 companies, there are probably 120 that are eligible for investment. These are companies that have earnings, a tangible and understandable business model, and so on. We have an internal working list that we generate each week that illustrates the price movements. It is a tool that helps us figure when companies "come on sale." Our tool is not much different than the weekly Globe and Mail 52 week highs and lows, except we add our own valuation parameters on as well.

Can you elaborate on your overall investment philosophy, and how it differs from that of other value investing firms?

We have been value investors for 38 years. Let's take a step back, because value investing is a big church and there are various religions within it. Value investing started out with the classic Ben Graham approach: looking for 50 cent dollars, for example a company whose assets are worth 10 dollars, but the market has priced them at 5 dollars, and the company has no net debt. Over time, the definition of value investing has broadened to include companies that have franchise value. Such companies have franchise value that is greater than their asset value. This could occur in any sector and it could be any company. It could be Cap-ex light, it could be cyclical, it could be non-cyclical -- that is where Foyston focuses. Warren Buffet has said that he was really only interested in companies that have franchise value. These companies could have almost no assets, like for example, Coca-Cola. Coca-Cola has the formula to make Coke, and they have recurring demand. You are not buying Coke for its PP&E; you are buying Coke for its brand. That is the 'quality' side of value investing. We operate between those

two pillars of traditional value investing and quality value investing.

You said that 120 of the 180 companies on your list you would be willing to invest in if the price was right. Do all of these companies meet your definition of value?

No, they are just on our radar. There is a quality aspect, and there is a valuation aspect. To invest in a company, it has to have both. It has to be a company you can understand, that generates earnings, has an established track record, and so on. And, you have to buy into the price. At any one time, we own about 35 companies, so about 35 out of those 120 companies satisfy all of our criteria. But, companies change over time. A company might have been a terrible company ten years ago, but something might compel you to look at it again. There are certain types of companies that we at FG&P don't like as much as others,; a classic example are gold mining companies that never generate revenue. There are some people that like buying gold companies, but, in general, they don't make a lot of money. These are companies that we don't invest in. We would invest in the resource space. For example, we like companies that make materials, such as metallurgical coal, trees, oil, things that we consume, that are bulk, easy to discover, and that companies can turn a profit on. So, meeting our criteria for value depends on the nature of the company, the business cycle, and at the market at the time.

If these companies were all priced attractively, are all 120 quality businesses?

We couldn't own all 120 because we are concentrated value investors. We believe in being different from the index. In order to out-perform the index, you have to be different from it. We would rather own a small group of companies, call it 30-35 that we know inside-and-out, better than anyone else, and that we believe will perform better than the market over time. So, concentrate it, hold it for a long time, that's our sweet-spot. We would never want to own 50 or 60 companies. We would want to be very selective and say "Okay, what is the best of the bunch?". We are always trying to distil our holdings down to those that represent the best quality and value. We would pick one out of four companies in that universe of 120, approximately.

Within your main fund, these 120 companies, do you strive for sector mixing? How do you go about deciding how much to invest in a given sector?

Our clients have investment policy statements, which put hard rules on how much you can invest in a particular sector. We can invest no more than 10% of the total portfolio in a particular sector. However, we do not take a top-down perspective. Given our value style, we sometimes find that companies in a particular sector are on sale. This happened in 2009, with the Canadian telecom companies, Bell, Telus, and Rogers, when Wind, Public Mobile, and Mobilicity, were all coming out of the woodwork and were going to buy mobile licenses. The perceived competition made the incumbents, all investable companies, all slightly different, cheap. At that point in time, we owned all three. The sector weight in the TSX was 3%; we owned 13%. We could make cases for all of them because they were such good value.
So, there have been times in our fund, and it always seems to change over the cycle, where we will own a lot of telecom, or a lot of the grocery stores. Right now we are heavy in the insurance companies; our weight is 12%, and the index weight is 6%. We are mindful that we want to be different from the index, but we are not top-down. We are very much bottom-up. When our holdings reach fair value, we will sell them down and look for where the next opportunity might be. We are agnostic.

What are some of the biggest challenges you experienced when you began taking on executive leadership responsibilities in addition to day-to-day portfolio management?

First, running a company and running a portfolio are different tasks. Part of me loves stock-picking and analyzing companies. Running a company is a great challenge as well. Each involves different skillsets. When you are running a company, you are dealing with people. The question is, "How do I get the best out of people so that we get the best performing portfolios?". That is something that I am challenged with every day.
The second thing is focus. You have ask yourself how time you want to allocate to which tasks. I have to be careful with my time, because it is finite. I have to say "Okay, I'm going to spend this much time on the executive functions, maybe six hours a week, and the rest will be focused on the portfolios." I try to delegate smaller things that I don't need to focus on.
As well, you always want to hire the best people. You always want to hire people smarter than you, because that makes your job easier. Don't be someone who thinks "Oh, I always want to be the top dog." Hire people that make you look good, hire people that are smart and passionate and motivated and who bring a complimentary skillset to the table. Those are some things that I am always looking for when building a team. Once you've selected your team, mentor, motivate, and develop them. Think about what will get that person excited, and give them new things to work on so that they learn more. For example, get them to work on different sectors, and think about what steps they need to take to become a Portfolio Manager. We are always trying to think of new things. We have 55 people that we need to keep motivated, and that is a very important task.

Do you find that you have to cater to individuals? Regarding motivation, personalities?

Yes. This is going to sound funny, but we have one individual in the firm: he doesn't have a girlfriend, he works tonnes of hours, and he is almost like an investment banker. He loves what he does. We noticed that he was parking his car in a lot nearby. Usually how it works in our company is that the senior people are the ones who get parking spots. But, we decided to give him a parking spot despite him being less

senior in the company. He was working a lot, it would save him time, and make his life easier, and he came in on the weekends anyway.

Another woman on our team sometimes has things to do with her kids on Friday afternoons. We give her the time for that and that pays dividends. It makes her life easier, and then she'll send John (my partner) and I a report on Sunday night at 11 o'clock, by that time I'm in bed! She'll pick up the slack when she can. We focus on the small things. You have to pay people competitively of course, but you should also think about the small things that make people love working at your firm and not want to leave. When you've done a good job and you hear the stories where a competitor tries to poach someone, and they say they are very happy at our firm and don't want to leave, that's music to my ears.

Some investors avoid Canada because it is a market driven by commodities, which are subject to great fluctuation. Where do you stand on the potential to generate above-average returns in Canada as compared to globally?

It is true that we have a lot of resource-driven companies in Canada. Even our large banks have exposure to resource-driven companies. Credit Suisse does a report each year where they look at expected returns for equities and bonds in various markets. Not surprisingly, the best market has been the United States and the S&P 500. I'm going to say that it has returned maybe circa 6% in over-100 year periods. I think Canada is around 5.5%. We are not quite as high, but in terms of equity return, we are pretty good. So, why would you invest in Canada? First, there are some unique companies in Canada that you can't get anywhere else. For example, Suncor, Imperial Oil, and Canadian Natural Resources. The oil sands are sometimes seen as controversial, but they have some of the largest oil reserves in the world. So, we can manufacture oil, and not have to drill a hole, let it come out for a while, and then find another hole. Here, the oil is in the ground, 200 feet deep. All you have to do is take a shovel, dig it out, and process it. I'm making it sound way easier than it is, but my point is that these companies have reserves that are measurable for decades. The cost of producing is competitive, and you don't have oils sands anywhere else in the world.

Another example is Canfor, a lumber company. There are lumber companies all around the world, but Canada have very unique lumber companies because they are exporters to the United States, and China because their product is so good. You won't see these companies in the United States, just because of the way their economy is structured.

And, our banks. Death, taxes, and owning a Canadian bank stock is pretty much guaranteed for all Canadians. You can buy banks anywhere in the world, but our banks really are the very best in the world. They generate the highest ROEs, they have probably the best risk controls, and their valuations are still, I can't believe I'm saying it, cheap. They are better than U.S. banks, and they are cheaper than U.S. banks. And they are cheaper relative to Australian banks – even though the Australian structure is remarkably similar to Canada. The Canadian banks are high quality assets. The Canadian banking sector has a 70% probability of outperforming the TSX over a long period of time; incredibly good odds. As a Royal Bank shareholder, you know about getting 'paid to wait'. The very first stock I owned was Bank of Montreal. I owned it as a kid – from delivering papers and things like that, and I didn't sell those shares until I bought my first home. It was my down payment, and then some.

My last point, the most important thing, is that you should have some money in Canada because the Canadian market is inefficient. We are stock-pickers. We are telling clients that they don't need to own the TSX index because we will add value beyond what it can provide to them. Our main fund has added value over many years. But, any inefficiency means that the probability of succeeding in Canada is higher than the United States. You want to look for inefficient markets, you want to look for markets that have weird indexes, so you can outperform.

The last simple reason is that if you are going to retire in Canada, you want to own some Canadian equities, so that you don't take on currency risk. If you can own a very high quality basket of Canadian companies, you don't need a lot of them in that basket. If you are investing as an individual, you can buy 20 high quality Canadian companies that pay dividends, and you can put that toward your retirement. There might not be as many companies as there are in the U.S. or Europe, but there are still more than enough to make an investment case.

In George's class, he says every investor should have a Canadian bank and a tobacco company.

Yes, tobacco companies are the investor gift that keeps on giving. They do not quite give all good things for society however. We used to have a tobacco company here in Canada called Rothman's, but it got taken out a long time ago. You can buy British-American tobacco, we have that one in our global fund actually. And, yes, everyone should own a Canadian bank.

You said that there are unique investment opportunities in Canada, such as the oils sands. Are there are similar opportunities that are exclusive to the U.S?

I will answer your question a little differently. In Canada, there are definitely parallels to the U.S. market: think about the railways. When we do our job in Canada, we like to look at the U.S. parallels. For example, I'll look at AT&T and Verizon when I'm looking into Canadian telecom companies. Another example is the grocery sector. Think about who just got bought – Whole Foods. The market was scared that Amazon was going to re-define the grocery business, so grocery stores in the U.S. were very cheap. The Canadian ones are more expensive. You have to be mindful of that, because they are very similar businesses. Demand for groceries is relatively finite; it doesn't grow that much. We try to look at both markets.

One thing that you get in the U.S. that you do not get in Canada is quality healthcare companies. As you think about investing globally, the U.S. is very deep in healthcare. We have Valeant, which isn't a great company. We just don't have healthcare companies. You don't have quite the consumer staples companies that you have in the U.S., like Proctor and Gamble, Kelloggs, and General Mills either. Tech in Canada is very slim also. There are really only five companies: Constellation Software, Shopify, RIM, CGI Group, and Open Text. In the United States, you have the epics: Facebook, Google, Apple, and even more traditional tech like Oracle, Microsoft. Tech is a much deeper market in the U.S.

A lot of value investors say they avoid tech because they just don't understand it, or they think it is over-valued. What is your take?

Tech is challenging. The valuations that the market is prepared to pay are huge. For a traditional value investor that looks at earnings, it frankly doesn't work. I will take a bit of a devil's advocate position here, with Amazon. Jeff Bezos has shown no aspirations of actually making money. But, he hasn't raised truckloads of equity; he is self-financed. Even though from a GAAP perspective he hasn't really generated earnings, from a cash flow perspective he has deferred profitability for the very long-term. This is a contentious debate within the value community, because he has in fact generated value.

For traditional value investors that value companies based on their earnings, its hard to wrap your head around. Some value investors have invested in Amazon and Netflix, but that is not really our style. We believe in companies that make a profit. Both Open Text and CGI group are profitable companies, with growing earnings on a per share basis. Further, they are earnings that we can get our head around. Bezos has done a great job of convincing people to buy his shares, but we don't feel the need to be part of that for now. However, I do not think that you can dispute that he has created some degree of value. If you bought Amazon shares ten, or even five years ago, you would be an incredibly happy camper. But, if you had bought shares of CGI group five or ten years ago, guess what, you are probably pretty happy too.

You have an emerging markets fund. A lot of value investors steer clear of such funds, while others cite the need to have 'Boots on the Ground' if you do have them. How do you invest globally from downtown Toronto?

Our emerging markets fund is really an in-house fund; we only have about 65 million dollars in it. I think you can run an emerging markets fund from a developed country, because there is so much information that is shared electronically. I guess, arguably, that has been the great democratic influence of the internet.

The second thing is that you can always fly to the countries; you have to do that as well. You can't just invest from an ivory tower. The challenge is when you are dealing with countries where the markets and property rights aren't quite as understood, and where corruption is more commonplace.

And the other big challenge is currency. One thing a good emerging markets manager must do is have some degree of knowledge on how you deal with currency risk. You buy a great company at a great price, but if the currency goes down, it is all for naught. As a Canadian manager, that is something that I don't have to deal with as much because my companies generate revenue right here in Canada. Although with our large-cap portfolio, a third of our money is generated outside of Canada, a lot in the U.S., but it's not as big a deal as in emerging markets. You can absolutely run an emerging markets fund, but you must travel.

Pavel Begun of 3G Capital Management has commented managements' tendency to bias investors when they visit, his aversion to company site visits as opposed to informed research.

Well, I guess that is what makes the market what it is; everyone has a different opinion. My personal view is that you have to visit a company from time to time, even knowing full well that they want to sell you their shares. That being said, we are trying to triangulate. For example, when you see a bottler, perhaps, in Chile, South Africa, and Czech, you start to form a basis for comparison. With our global team, this is what we do. Globally, there are a ton of companies, so we try to find companies in better sectors to make the process easier. We start by defining what sectors we want, we like bottlers of predictive consumer bottles. In Vietnam, beer sales are going through the roof because there are a lot of young people travelling there, and that's great for Heineken. So we look at Heineken, and we look at some other beer-related manufacturers or bottlers. And we look at some other sectors that have a high pre-disposition to growing and generating good profits. We then compare companies within that sector to see if we are generating good value. We could be getting a snow job from a company in South Africa, while a comparable German company is too pessimistic and too honest with us. That's what we try to do with triangulation. You want to come to an insight that the market hasn't appreciated. I think there is value in going to see companies for sure.

If you were to come across two identical companies; one in an emerging market, and one in Canada, what additional research would you do on the one in the emerging market?

Well, I think the research process would be somewhat similar. Obviously, you will be doing financial analysis, trying to understand the economics of the business. I spoke about the currency side; you have to do some risk overlays on how you think about currency and portfolio compilation. You also want to talk to management. Sometimes language can be an issue. The amount of disclosure in English as compared to their local language might be different; sometimes we need help with that, and we might try to get a local broker to help us out. Sometimes, the transparency is just not quite there so

we may have to do a little more research on that.

I'll give you an interesting example. There is a Brazilian beer company called AmBev, which also happens to have assets in Canada, oddly enough. We compare it with Heineken, a European bottler, and Molson Coors, Budweiser. Because the emerging markets are riskier (corruption, currency, property rights, liquidity in the stock market), you have to be extra cautious on the price you are willing to pay. Those are the extra risk factors.

You said that your fund typically holds about 35 names, each with a maximum weight of eight per cent, and the top ten with a maximum weight of 55%. What is the maximum weight that a single holding comprises, and why did you choose to invest more in that company than others?

In Foyston, we have an investment grade checklist, which helps us compare the quality of companies. You give them a grade, five through one, with the lowest being a five. If we have a company with a grade of five, we do not hold more than two per cent of it in our portfolio. If it has a grade of one, we can go up to eight per cent. It is our quality and risk control mechanism.

A large cap with a grade of one in Canada would be RBC or TD, but there aren't that many 'ones'. An investment grade of two could be CIBC or Great West Life. An investment grade of three might be Thompson Reuters, a good industrial company, diversified, but not quite as bullet proof. Magna, a great parts manufacturer, but still in a cyclical business, would be a three. A four and a five would be Precision Drilling, a service company in the oil sector that is a little risky. We own Bombardier, but they have an enormous amount of debt, and it is a very low profitability businesses, it would be a low investment grade, likely a five.

Would most of the 'ones' be invested at around eight per cent?

No. Eight would be our cap. I think our largest holding is in Bank of Nova Scotia, and that is around seven and a half per cent. I think our typical weight is between two and four per cent.

The simple investment case for Bank of Nova Scotia is that it is a top three bank and a very high quality business, but it trades at a discount to the bank sector. We think it should be trading at a premium, and it is actually trading at a discount. It has the second highest dividend yield of large cap banks. It has amazing growth prospects, and an amazing track record. There are a lot of good reasons why we have it as a big weight in our fund right now, but, if it gets too big, we'll have to sell. That's a hard rule, it's called portfolio risk control. You don't necessarily want to put in a big weight because you want room for it to grow. You might put it into the portfolio at a two per cent weight and hope it grows to four per cent within a few years.

Have you made any niche investments? Unconventional? Or small/ obscure companies?

I think Canfor is one of the last ones we put in. Most people won't know it. Canfor runs sawmills, buys timber mostly from the government, and cuts it into two by fours or shingles. They are a value-added forestry company, based in BC. They sell to China and the U.S. Think about who buys logs typically used to build homes, furniture, and decks. What is the investment case? With any commodity company, they have to sell a lot, and the price has to go up. The value added producer should be able to transform the log into a final product very cheaply – more cheaply than anyone else can. In the last ten years, the demand for wood has been going up. After the credit crisis, during which the demand for homes went from 1.5 million down to 900,000, the demand for homes then started to grow again. There is not enough timber in the U.S., so they have to import, and so demand goes up. Additionally, the people that own the trees and sell the logs aren't the same people. For years, there was low demand for timber, so the price of the logs was very cheap. Canfor buys the logs for nothing, but demand is increasing in the U.S. and in China. Also, the mountain pine beetle killed all the pine trees in Western BC. They eat the wood and destroy the trees. Supply has been reduced while demand has gone up, so prices go up. Canfor has been the beneficiary of all this demand for lumber in Canada, the U.S., and China. The supply of logs that Canfor buys in the U.S. is really cheap because they haven't sold in years. We bought at $21, and now it is at $31; that's a 50% return over two years, which is pretty acceptable.

You talk about how the outlook for Canfor seems to be favourable, what about its competitors?

There are competitors. West Fraser is the largest in Canada, then Canfor is number two. They both have done very well.

How did you pick between Canfor and West Fraser?

Both are investable. We came to the conclusion that we liked Canfor better on a valuation basis, because it trades at a discount to West Fraser since it is the number two company. And in the weird world of capital markets, when a U.S. investor wants to come to Canada and invest in forestry, they always pick West Fraser since it is the biggest and it is more liquid. We liked Canfor's cost structure and we also really liked that Jimmy Pattinson, a multi-billionaire, owns about half of the company. We feel comfortable investing alongside him because he is a great investor, and a very bright guy. One thing that Jimmy demands of his companies is that they have low debt. Canfor doesn't have any debt and doesn't pay dividends. They don't know what to do with their cash, so we've been talking to them about that.

As an Ivey grad, what did you value most about your experience here? What advice would you give to current students?

I must admit that I made a lot of very good friendships at the school, and I stayed in touch with a lot of classmates. I was in the airport in Montreal the other day, and I ran into an old housemate. Even today, I ran into another old

classmate on Yonge Street on my way here. So it's just a great network of people that I can talk to about business, but also socially. I would say the professors that I had at the time were really inspirational. I was really lucky to be in the right place at the right time. I am still grateful.

In terms of advice: be humble, don't be cocky. I'm finding there's some entitlement present these days. It's important that students remember that they have to be humble, pay their dues, and work hard. Get into work early. Don't come in at 9am with your head phones on. Come in at 6:30 or 7am. Be really serious and be hungry. Don't job-hop; try and stay somewhere for at least five years. Show progression and grit.