RUSSIAN DOPING AND THE FINANCIAL MARKETS

2010 was a great year for Canadian sports. Vancouver hosted the winter games and Canada had its best ever showing, leading all countries in gold medals, capped off with a huge 3-2 win over the United States to win gold in men's hockey. Russia on the other hand had a dismal performance. The Russian team placed sixth, its worst performance ever.

Determined not to be embarrassed during the upcoming Sochi Olympics, Russia devised wide reaching, state sponsored doping programs to ensure its athletes placed at the top of the medal count leaderboard on home turf. A report released earlier this week by Canadian investigator Richard McLaren reveals how the Russian doping programs worked.

Quoting the Globe and Mail:

> "*The first, run out of Moscow's World Anti-Doping Agency-approved testing lab, involved what Mr. McLaren called the "disappearing positive methodology". All positive tests would be referred to Russia's deputy minister of sport, Yuri Nagornykh. From 2011 onward, Mr. Nagornykh personally decided which positive tests would be registered as such and which would be discarded…Discarded tests would then be registered as negative, and the results of the test falsified by laboratory staff. With the presence of so many non-Russian lab staff during the Sochi Olympics, a different system was devised.*
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> *In the months leading up to the Sochi Olympics, doping Russian athletes created a bank of clean urine samples during "wash out periods" when they were not using performance-enhancing drugs (PEDs). Those samples were tested to ensure they were clean, and stored in freezers. Operatives of the Russian Federal Security Service (FSB, the former KGB) devised a method to remove the lids from tamperproof testing bottles without detection. At night, dirty samples were moved from the laboratory into an adjacent room, where they were replaced with clean samples. This transfer happened through a "mouse hole" in the wall and was assisted by FSB agents."*

The Russian PED scandal got us thinking of the parallels to the world's current financial markets.

Following the dismal performance of the global economy during the financial crisis in 2008/09, and determined to save us from financial ruin, the world's central banks initiated their own doping program, administering a consistent dose of easy money and low interest rates to financial markets.

Back in school we learned that the risk free rate, the theoretical rate of return of an investment with no risk of financial loss, was used as the basis to value all other assets. For practical purposes, the return of domestically held short dated government bonds is a good proxy for the risk free rate, with the US being the global benchmark. Now, we do not profess to be "macro guys" but if central banks are suppressing interest rates via their quantitative easing programs, is it not possible that they are in fact administering their own version of PEDs to the world's various asset prices? We do not have a definitive answer to that question but we can tell you one thing: finding attractively valued businesses in today's global markets is becoming harder and harder each day.

For athletes, too many PEDs over a career can have devastating long term physiological and psychological side effects. We think the same risks are present in the financial markets. Too low rates and a lack of return opportunities have many investors taking on too much risk in search of yield. At some point, asset prices run too far, for too long and become so fragile that the slightest sign of trouble results in substantial losses. We saw a recent example of this on the Brexit vote. The market's reaction saw the British Pound sold down to levels not seen in 30 years. UK companies were sold almost indiscriminately. The response from investors was as it usually is to these types of events, "sell first, ask questions later."

If in fact low interest rates are acting as PEDs for today's financial markets, how do we ensure we are not taking undue risk to achieve attractive returns? The answer is simple. Our investment discipline is based on buying excellent businesses with a margin-of-safety. This approach requires careful consideration of factors including the competitive advantages enjoyed by the businesses, the profitably of the business, the abilities of management, the reinvestment opportunities for the business, and the price at which shares in the common equity can be purchased in relation to our estimate of intrinsic value.

We focus on the price we pay and ensure that we only invest in a business when we believe it is trading at a significant discount to our estimate of intrinsic value under *a normalized* interest rate environment. This ratio of price to intrinsic value is the core of our risk management process and our investment philosophy because we believe the management of risk, not the management of returns, is the best way to meet our clients' long term investment objectives, regardless of market conditions.

The Brexit turmoil afforded us the opportunity to allocate approximately 5% of our pooled funds' capital over the week following amongst current investments and an initial interest in a new holding based in England, which we hope to update you on in future commentaries.

We thank you for your continued support.

Sincerely,

Adam Donsky, CFA, *Chief Investment Officer*
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