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H&R: A lesson in patience and persistence

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A stock considered cheap can always get cheaper, but eventually this REIT lived up to another timeless adage

Ben Cheng, president, Aston Hill Financial Ltd.

The Investment:

H&R REIT HR.UN-T

The Background:

"H&R signed a contract with Encana to build the Bow Tower in Calgary, and construction began in 2007. They entered into the project under the basic premise that financing and construction costs would not become seriously out of whack for what present events were back in 2007.

"But, as we know, the world fell apart in 2008. ... Around July, 2008, we became quite concerned about our investment in H&R. So we sold the stock at $18."

"But H&R has strong management, and the portfolio of office towers they own across Canada is arguably one of the best office real estate portfolios in the country.

"We recognized that, in a normalized environment, H&R was probably worth its net asset value of about $16 per unit. So, in November of 2008, when it got down to $8, I thought it was wonderful because, yes, while the financing and construction costs could crush them and the stock could go to $0, they could rebalance their balance sheet, perhaps sell off some assets, perhaps cut the distribution, and the stock could go from $8 to $16."

The Return:

"In November, we bought the stock under $8, and it proceeded to go to $7. We bought a little bit more under $7, and then it went under $6. We bought a little bit more under $6 and then it went under $5. Then the reality check set in. Because our logic at $8 wasn't making any sense as the stock was trading in the $4 range.

"It was quite difficult. There were other parts of our portfolio that had dropped precipitously in value, but with this one, we thought we were smart, because we sold at $18 and ended up buying in the $8s. But then it went down to the $4s, so, obviously, we weren't that smart.

"But at the end of the day, our average purchase price was right around $7, and the stock has gone from a low of $4.50 [Nov. 24, 2008] to $17.16 [Friday, July 9]. We didn't buy at the low, but I do remember purchasing stock in the $4s.

"In January of 2009, H&R cut its distribution in half. But even so, the stock rallied tremendously during the year. For the year, the stock returned 117 per cent, and if you'd reinvested your dividends, you would have made 122.6 per cent.

"The company has since announced that it is on pace to raise the distribution starting next quarter, and it will raise the distribution every single quarter until 2012. So the distribution will rise from 72 cents a year to $1.05 a year by the second quarter of 2012. So the company's obviously doing much better."

The Takeaway:

"We still own H&R and I still like it, but having the ability to buy more stock under $5 when we had made what we thought was a very intelligent purchase at $8 taught us a lot about how much we still have to learn from the markets.

"There were two lessons.

The first is that as much as we think a stock is cheap, it can always get cheaper. It's a simple lesson, but it was a lesson learned, nonetheless.

"I always remember some of my old mentors' wise words: Markets can be irrational for much longer than you can be liquid.

"We had no leverage in the fund, so we had no pressure from that standpoint. That was important. In November of 2008, if we had been operating a leveraged fund and were feeling the pressure from the banks, our outcome might have been very different.

"But with H&R, we did the work, we had a good understanding of the value of the company, and we stuck by our investment thesis.

"So the second, and most important, lesson was this: As long as you do the work and you understand the value of the company, yes, markets can do silly things over short periods of time, but if you always reassess yourself, always reassess your work, and it continues to make sense, then you have to stick by your investment. In this case, we did, and it all worked out."