

# STRATEGIC CAPITAL PARTNERS INC.

## A Penny Earned is a Penny Saved

A recent interview with a prospective client, we'll call him "Mr. X", made us think we ought to remind our clients what we regard as "risk" and our role in "managing risk" for our clients.

Mr. X is retired, has several millions in investable assets, currently in fixed income securities, a luxury paid up house and a Florida condo. In his view he had enough to enjoy the rest of his life, if he didn't lose. For him, capital preservation, avoiding risk of loss, was paramount. Sounds sensible. But, sometimes standing still isn't safe. As under a tree in a lightning storm.

Like Mr. X, many investors are content with sustainable, consistent, albeit low, returns of fixed income. When agreeing on a mandate with new clients, we always suggest that they only need income in their portfolio if they can't withstand a substantial short-term decline, either because it would impact their lifestyle, or because they don't have the temperament to hang on at market bottoms. We don't want our clients to be locking in losses at exactly the wrong times. Selling when they should be buying. And, we certainly don't want to alter the sleep patterns of any client.

But, stocks, over time, give the highest after-tax returns. And we're there to provide the temperament and discipline to buy when others are selling and sell when others are buying.

Then too, fixed income isn't without its risks. As it turns out, some of Mr. X's fixed income was in foreign securities, implying currency and, maybe, country risk. Some in longer dated securities, implying inflation risk. Some in short dated, low yielding securities, implying no real return after inflation and taxes, not to mention opportunity costs.

### Unreal Estate

Mr. X feels secure with his real estate. But, though they are not quoted moment by moment as in the case of the computerized auction market for stocks, bonds, and commodities, the price of his house and condo fluctuate too, just less perceptibly. Sure, you've got to live and vacation somewhere, so housing is in a different category. Homeowners tolerate the ups and the downs in the belief there's no real choice and over time the trend is up anyway.

Guess what, the trend in stocks, over time, is always up too. Over time, stocks are the best performing asset class compared to real estate, whether residential or farmland, and compared to fixed income, precious metals or collectibles—the prices of all of which fluctuate. Housing has certainly had its periodic downturns and, if mortgage rates continue up, they may yet again, particularly from current inflated prices. Over the last 5 years, new single family house prices are up 34% whereas the S&P500 is down 16%. Hmm, which is more likely the bargain? Other than because of the pleasures derived from home ownership, from a purely economic standpoint, personally, we would rather own *Pan-Ocean*, for which broker Griffiths McBurney just raised its price target to \$60, a one year potential double. If that's the case, those returns would allow an even better home and, likely, one for each of the kids too. Point made. Back to reality.

Reality is, that the prices of all assets fluctuate, stocks probably more so, making our returns often lumpy. And some people can't sleep well with the prospect of lumpy returns. But leaving their money under their mattresses can create lumps and sleepless nights too.

Reality is, that since the prices of all assets fluctuate, it's less risky to be in the ones that are liquid such as stocks and bonds, which can be easily disposed of if a downturn is perceived or acquired quickly if an upturn is underway. All it takes is a phone call to a trader. You don't need a real estate broker, a listing agreement, conditions, a 5% commission, a brochure, open houses, inspections, legal fees and sometimes weeks or months of fretting, not to mention the garage sale. In the meantime, there's no ongoing maintenance or real estate taxes.

Homeowners seem to readily accept mortgages of 75% of the value of their homes (or even up to 100% in some cases today) and rely on price appreciation and some principal amortization to make them safe. But a modicum of tax deductible margin interest, even on profit producing or, better still, income producing, marketable securities is anathema to them. Go figure.

### **Equities Best in Class**

Sure, capital gains on principal residences are tax exempt (in the US with some limitations), but dividends and capital gains, in the US and Canada, get preferential tax treatment, so after-tax returns from equities are generally far better than on other asset classes such as real estate or fixed income. And unlike the returns on fixed income which can't be deferred for tax purposes, taxes on capital gains on stocks are only paid when realized, which could take years, greatly enhancing returns on invested capital.

Equities are generally the best asset class because they represent pieces of businesses that generate earnings which are redeployed to grow more earnings that, in the end, will result in rising retained earnings and, ultimately, in "dividends" to the owners, one way or another. That's the distinction from a non-income producing asset like housing or hard assets like collectibles and precious metals. Housing prices depend on favourable demographics, interest rate levels, affordability, confidence from a satisfactory economy and costs of land and construction. Those same general factors affect businesses too but, again, businesses produce revenues which after costs produce earnings and ultimately dividends. A true investment. Interestingly, buy one house and it's an investment in home ownership. Buy a second, to flip, and it's a speculation. Likely, therefore, any home ownership in excess of the owner's actual lodging requirement could be considered speculative.

We did explain to Mr. X that, first and foremost, we're value managers. We buy financial assets that we don't believe to be excessively risky, at a significant discount to our appraised value of those assets. The bigger the discount the lower the risk. As a bonus, the bigger the discount the higher the reward. Lower risk, higher reward. They don't seem to teach that at business school, where it's usually the received wisdom that high rewards necessarily go hand in hand with higher risk.

The very nature of what we do at Strategic is endeavouring to manage risk. We create “portfolios” with varying composition depending on the clients mandated requirements and how we intend to achieve satisfactory returns with controllable, concomitant risk. Unlike one having all his money tied up in a house, or even in real estate generally, we diversify, often by asset classes, but always by groups and within groups. We diversify so that no mistake can hurt too badly. But we’re also not afraid to emphasize, as when we think a sector, such as the oils, or an individual company, such as Pan-Ocean, has prospects that are clearly significantly superior yet has unusually low downside risk.

And we create ever changing portfolios, by definition an exercise in managing risk. A large universe of publicly traded securities allows us to diversify sensibly, to overweight oils and golds when propitious and, on the other hand, to avoid autos, airlines and other groups that may appear dangerous. Best of all, we can move quickly to change the mix when we change our views. To raise cash, say, or go short.

And, if we like real estate as an asset class, we can invest in it too, through publicly traded real estate businesses, like real estate investment trusts *Huntingdon* and *Lanesborough*, which we currently own in income accounts, because they each yield 10%, and likely higher next year, from their rental properties. Income producing. And we can even sell short real estate stocks like high end US house builder *Toll Brothers*, when we think, as we now do, that housing may slow in the face of rising mortgage rates and waning consumer demand. If only homeowners could hedge against the risk of their currently inflated house prices coming down.

We recognize that this discussion is purely academic. We all love our homes. Randall also has a cottage in Muskoka and Herb a condo in Florida. Not everything is measured quarterly in dollars and cents. Home ownership can give you the pleasure of gardening, watering flowers, pruning weeds. So too with portfolio management where we want to water the flowers—stick with and add to the winning positions. And prune the weeds—quickly eliminate the losers. Liquidity is a great advantage in risk management. When stocks get high, we can lighten up and when value abounds, because others are fearful, we can add. We see these fluctuations of liquid securities not as risk, but as opportunity. Sensibly, methodically taking advantage of fluctuations in a secular rising uptrend seems to us to lessen risk.

## **Risky Business**

And, with a view to minimizing risk, we take a top down and bottom up approach to investing for our clients. We need to have preferences for particular asset classes. With interest rates near 23 year lows, long-term government bonds don’t provide a satisfactory after-tax, after inflation return. Especially, too, with a flat yield curve where investors are not rewarded for buying longer term securities and taking extra risk. Two year notes yield 3.98%, 10 year bonds 4.16% and 30 year bonds 4.38%. Now the US government intends to start issuing 30 year bonds again. Maybe it suspects more inflation is on the horizon, especially if the dollar tanks, so it wants to start “locking in”. The game is always “shaft the lender”. After all he’s likely only a foreigner or elderly anyway.

Why are stocks generally better? Because they're really perpetual bonds whose earnings yield adjusts for inflation. The coupon isn't fixed, it can grow. Companies own hard assets such as real estate, equipment and inventories that go up with inflation. Which is why equities do better than bonds in inflationary times. And since companies borrow money and equities compete with bonds, they also do better than bonds when rates are low and bonds are less attractive. It's only when real rates are very high, such as in the Volcker era of double-digit rates in the early 1980s, that stocks don't work. Stocks are almost always better and currently are over 30% undervalued in this interest rate environment where the earnings yield is 150 basis points higher than the yield on medium term government bonds. Higher yielding 3-5 year term corporate bonds and selective income trusts are preferable to government bonds too, and generally that's where we've been investing our income accounts.

From a risk avoidance standpoint, we worry about the US dollar and the potential for a currency crisis. There may be some large holders of dollars out there who are starting to feel uncomfortable. Japan and China, for example, with their megaholdings of dollars. China is buying *Petrokazakhstan*, and tried also to buy Unocal, for their oil production, but, likely, also to exchange some unwanted dollars for real assets. Japan, Europe and Latin America seem to be improving which could make them less dependent on exports to the US and make their currencies more appealing.

The trade and budget deficits stay stubbornly high as does record total US debt relative to GDP. The highly indebted US consumer continues to spend excessively, relative to his income, yet retailers are slowing from the drag of high oil prices and rising interest rates. That leads us to want to hedge our US holdings and to look for investments in US multinationals that should benefit from a declining dollar. And makes us want to continue to overweight golds.

From a macro standpoint, in order to determine whether to invest in stocks or bonds, and if stocks, within which groups, and in which countries would we feel most secure, we need to consider currency risk, the inflation outlook, the economic outlook and political risk.

Here too we consider country risk. We pruned Petrokazakhstan because the Kazakhs were getting greedy, partner Lukoil seemed insidious and insiders were selling. Too early it seems as it just got taken out by the Chinese national oil company. But, okay, because we still did very well. We continue to water our flower, Pan-Ocean, because Gabon looks like a safe place to be alongside the two other major players in the country, Shell and Total. A good fiscal regime. Tanzania looks favourable for *EastCoast Energy*. Romania okay for *Sterling*. India good for *Canoro*. Egypt and Pakistan for *Rally*. Russia a little tricky for *High River*, but Burkina Faso should make up for it. We avoid Venezuela because Chavez is right up there with the Kazakhs. Pat Robertson thinks so too. South Africa is difficult with black empowerment, miners strikes, an HIV epidemic and a high Rand, although we think conditions should improve and just bought more *Etruscan* (diamonds in S.A. and gold in Niger) in a recent financing.

## Smoke and Mirrors

We need to know what's the real deal. These days we think there's some smoke and mirrors obfuscating the reality. Real GDP growth (Q1 3.5%) and employment numbers (5% unemployment in June) seem robust allowing the Fed to continue to raise rates, recently for the tenth time, ostensibly to encourage savings, discourage consumption, and keep already seemingly low inflation at bay. But the trade deficit for June of \$58.8 billion should cut into GDP growth. Retail sales ex autos (and they're giving those away) were up only 0.3% in July. Retail is slow, even at places like Payless ShoeSource, the mighty Wal-Mart and Dell. The Limited and GAP both just warned. Back to school sales are weak. Movie attendance is down 20% this summer over last year. Consumers are stretched. And layoffs abound. At GM and Ford, at airlines, IBM and Xerox, but even at safe-dependable, Kimberly-Clark, which intends to lay off 6,000 people or 10% of its workforce. Industrial production for July rose a disappointing 0.1%, durable goods orders were down 4.5%, capacity utilization declined to 79.7%, housing starts were down 0.1% and, while new home sales were up 6.5%, existing home sales for July were down 2.6%. Slowdown?

No inflation? What about house prices, the consumer's major asset, which over the last several years have risen far greater than the Consumer Price Index? As has the CRB Index of commodities. And, of course, oil is at \$66 a barrel and counting. Airline prices are rising as fuel prices need to get passed on. GM and Ford just gave away their 2005 models, but are in the process of raising prices for 2006 models and eliminating discounts. Toyota signalled it is raising its prices too. Everyday high prices. The cost of housing, heating, electricity, transportation, education, healthcare and anything imported from China is rising. Everything's going up, except inflation, we're told.

The budget deficit seems to be diminishing. Now, apparently *only* a \$331 billion deficit. Only 3% of GDP, 5% of the national debt. From higher tax receipts, we're told, because tax cuts have made the economy stronger à la the Laffer curve. But how much assist is coming from the repatriation by multinationals of billions of dollars squirreled away in tax havens at the one time moratorium rate of 5.3% tax? Even at this rate of reduced budget deficit, the national debt would double in 23 years. Social security, medicare and other commitments are enormous going forward. And what if the economy slows or rates rise?

Admittedly profits generally look okay. But costs are rising and many companies are having difficulty passing them on. They likely will. And general prices will rise.

If things are so good for employment, why is the help wanted ads index poor and layoffs high? Why is wage growth anemic and labour so restless? Even the AFL-CIO is in turmoil as the Teamsters and Service Employees leave.

Is housing a "bubble" or are prices just at record highs but sustainable levels? Call it what you will, but in assessing the risk, it suggests to us that as mortgage rates rise so will foreclosures, affordability, already at 14 year lows, will suffer, prices will decline, and generally the economy will slow. It just happened in Britain. It's a real risk and we factor it in constantly.

We've said in the last several quarterly letters, a slowing economy and rising inflation means stagflation, a tricky environment in which to invest.

## Good Companies

So much for the big picture. Now when we buy individual companies, to minimize risk, we want to buy “good ones”. They can be small, medium, or large. But they must be good. Good means they have to have earnings, not just a concept. Growing earnings, though a temporary glitch might have made them a bargain. The only exception to the earnings requirement is in the case of a resource company which may have significant undervalued resource assets soon to be developed. Near earnings. And they need to have good balance sheets which means not a lot of debt. Many of our companies have no debt. And they have to have intelligent managements we respect. And, needless to say, they have to be bargains, trading below their private market values, at price to earnings multiples below that of their peers and of the market generally and/or at discounts to their net asset values.

We like to purchase what’s below the radar screen. *Connacher Oil* is an excellent recent example. At 47½ cents per share just last December, we helped refinance it when it was an unpopular company. Based on the recommendation of the only analyst who followed the company, Andy Gustajtis, one of our favourites, we were persuaded that Connacher had tremendous assets with western Canadian land holdings alone worth more than double the share price. And, we were paying virtually nothing for the company’s massive oil sands potential and its highly prospective Peruvian subsidiary.

An engineering study in early August confirmed that just one of the company’s five potential heavy oil pods alone has a present value in excess of \$3 per share. The stock quickly ran to \$2.50 and based on a short-term sell signal from our SVA™ work, we reduced our weighting. The company just did a \$75 million financing at \$1.85 and we were able to rebuild our weighting in this company with a now reinvigorated balance sheet. The company still remains underappreciated. We could justify the \$1.85 share price as a bargain by simply adding its \$0.60 per share in net cash on hand from the financing and its land value alone. Yet the company has a world class reservoir (directly adjacent to an existing oil sands operator) which is fully exploitable by conventional horizontal drilling and steam stimulation. Production should start in late 2006. We think Connacher has the potential to be \$10 in 3 years.

It’s similar to several of our other holdings where we believe the market is missing the story. Whether it’s underappreciating *LaSenza’s* franchise and growing earnings stream, misunderstanding the impact on *Specialty Foods* from the temporary import ban on beef, being too shortsighted with *Canoro’s* drilling results from its Indian oil basin or completely ignoring *Rally’s* Pakistani natural gas discovery, we believe the market will eventually recognize value and reward us for our patience.

Most investors think smaller companies, unfamiliar names, must portend risk. But household names, like Nortel, Tyco, Worldcom, Enron, JDS Uniphase, TimeWarner, UAL, Delta, Air Canada, Stelco, GM, Ford, and recently Dell, Cisco, and Bank of Commerce, have all caused losses by disappointing the market.

Yet little *Connacher Oil* and *Leader Energy* have given us great satisfaction. Simple stories with good potential. Probably more volatile because they’re less liquid, but because they are more easily analyzed, have, we think, less chance of a negative surprise.

We've made some recent sales: *Nextel*, where the company was approaching our appraised value, and a portion of our *Delta Petroleum* position as the company gave a short-term SVA™ sell signal.

And, we also plan to increase our short sale position somewhat, even if temporarily, as the markets seem to us to need a short-term correction.

## Low Flyers

Risk for us means exposure to the potential for permanent loss of capital. Minor fluctuations caused by temporary changes in sentiment don't count. Bank of Commerce, recently down 11% in two days after announcing its US\$2.4 billion Enron settlement, may come back. But Enron won't. And don't bet on Nortel getting back over \$100 soon. When we get concerned, as we do from time to time, we can raise cash and shrink market exposure. And even better for our long/short accounts, by short selling we can actually bet that certain overvalued equities will decline—a more powerful hedge against loss. And move quickly with liquid positions. And if it makes sense to be in bonds rather than stocks, then that's where we'll be. Quickly too.

Making superior returns while they're safely available can compensate for inevitable mistakes or for when they're not safely available. A cushion, so to speak.

Risk means different things to different people. Business texts define risk as volatility—typically short-term fluctuations—“standard deviation”. Though we're conscious of short-term volatility, so as not to make the clients unduly anxious, this is not how we view risk. We think we're professionals that have a thoughtful appreciation of risk. And reward.

It's fair to say that, not just Mr. X, but most people are looking for return *of* capital not return *on* capital. But even with inflation running at 2.5%, after taxes, fixed income investors need 5% to stay even. What if inflation returned to 6% (July CPI was up .5% or an annualized 6% and PPI up 1%, an annualized 12%), not so farfetched since the asset of choice, housing, is running at least that. Mere return of capital would make one a loser.

As Randall's grandfather used to say, “It's not how much money you have, it's what that money will buy that counts.” Of course he also said, “Money can't buy happiness,” but it still tends to make us giddy.

He was right on both counts. The quantum of money Mr. X may have is only risk free if it maintains its purchasing power. That can be measured, for example, in its value against other currencies. We know he needs US dollars for his Florida condo and for his lifestyle as a snowbird. The purchasing power of money, in a particular currency, is measured by economists (by its purchasing power parity) in what it takes to buy some ubiquitous items, usually including a Big Mac, in various countries. We know, for example, that a Big Mac in Canada is still about 80% of the equivalent in the US. Which is why we can afford fries too.

It's also about retaining purchasing power. If Mr. X were to sell his house to do missionary work in Africa for 5 years, meanwhile parking the money in risk free 5 year treasuries, after taxes he would earn about 2% compounded per year or 10.4% total return for the 5 year period. If on his return to Canada he wanted to replace his home, based on what real estate has done over the past 5 years, he'd have lost over 20%.

So Mr. X deludes himself into thinking just maintaining the quantum of his money and earning a risk free return on it will protect him. Some smart guys think we are entering a highly inflationary period—if they're right Mr. X's stash will buy a lot less. Mr. X will be poorer even if he doesn't lose.

So sometimes a penny earned is a penny saved. Sometimes return *on* capital helps assure return *of* capital.

Our clients know that statistically it's safer to fly than to drive. But they are nonetheless more fearful of flying. It's more "volatile"(pun intended), much faster, and because a plane is so much more complex than a car to operate and navigate, it needs an expert to pilot it. So too with portfolio management. It needs expert pilots to get you to your destination on time, safely. Sometimes there is turbulence. If we think conditions aren't right, we'll stay on the ground until they're favourable. These days we think it is riskier to own airlines than to fly them. We use a lot of expert co-pilots to help us, both in Canada and the US. Industry analysts we rely on. Technical analysts. Economists. Market strategists. We try to discern the good co-pilots and navigators from the merely mediocre. The ones who are usually right. Piloting needs skill, but good judgement too. And if we do it well enough for you, maybe we can all fly first class.

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