Looking Through The Valley

"May you live in interesting times" is a notorious Chinese curse. Since September 11 we have been given an Afghan version that has taken the curse to an unimaginable extreme. And while we ourselves have now become self styled authorities on Islamic history, airport security, Canadian immigration policy, biological warfare and the dark side of human biological inclinations we will try to restrict our comments, crass as they may unavoidably seem, to the impact of these excessively interesting times on markets and your portfolios.

In our last quarterly letter we were continuing bearish as we'd been for a couple of years, believing the Dow Jones Industrial Average could probably hit 9000 and the NASDAQ retest its April lows. And we listed all the abounding negatives which we thought would, at least temporarily, overwhelm the positives. Principally, in our view, stocks were still overvalued, a residual of the biggest market mania on record, and that further correction was required. And we believed that the economy would worsen too.

The September Impact

Then came September 11. And all could clearly see that the economy would worsen. The "R" word was now accepted and even the "D" word was beginning to be whispered. The market worsened quickly too. By September 21 the Dow collapsed to 8100 and the NASDAQ to 1387. And markets all around the world made new lows too with most key markets hitting important support levels by September 21. But, importantly, U.S. short-term interest rates also moved down smartly, another full percentage point to 2.5%. And monetary liquidity was jacked up to unprecedented levels. And, understandably, psychology was at depressed levels from which rallies normally occur, if only from the exhaustion of the selling. So as the market crashed, on September 17 we published a Strategic Action Letter to our institutional clients advising them that support levels were in sight and one week later on September 24, in another such letter, we proclaimed the market a "Buy".

Our belief was that even with the reduced earnings expectations, based upon the new level of interest rates the Dow had dropped to a valuation level 40% below our calculation of its Fair Market Value. This represented a level lower than had ever been previously achieved since World War II, the lowest previous level being a 35% discount. We believed U.S. markets had reached powerful support levels from which to start a major up-move anew. With fits and starts no doubt along the way, but with a general upward bias. We believed this despite the fact that we also believed that the economy could worsen, markedly in fact. And that earnings would be down big time, that the consumer would be in saving not spending mode, that business spending would be cut dramatically, that unemployment would rise, that government budget surpluses would disappear, that bankruptcies both corporate and personal would increase, that the headlines would be foreboding, and that investors would give up on equities and flee to cash.

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But we also believed that the equity market being a discounting mechanism had in quick order descended to a level where it was now discounting all of the above plus also a protracted war on terrorism, the collapse of the airline and hospitality industries and the onset of a vicious economic circle which was being perceived as beyond the capability of government and central bankers to reverse.

On Monday, September 17, when the market reopened the Dow declined 7.1% and doubled that loss by Friday for its worst weekly performance since the Great Depression. Well, we observed at that rate of descent it would only take another 6 weeks for the Dow to be at zero, obviously an absurdity. The market was at about as low as it should go. On September 17, as the Dow plummeted 684 points, four stocks were down for every one up and volumes were huge. Capitulation? Were investors now throwing in the towel with the S&P 500 down over 30% from its March 2000 high? In our view, in stock market lingo, everything was "in the market". As market maven, Barton Biggs of Morgan Stanley once said, in order to for bear markets to reverse, the news doesn't have to be good, just not as bad as everyone perceives. Well, we think with the terror of the World Trade Centre attack and its awful human and economic consequences, the perception was and continues to be as bad as it could get. And it was all "in the market".

Misperceptions

Our work requires us to make judgements between what's a real risk and what's a perceived but less than real risk. We try to compare perception versus reality and look for the opportunities to capitalize on the misperceptions. Value investing is about exploiting misperceptions. That's how mispriced assets, "bargains", are created.

Here's how we see the misperceptions. The world is on the verge of becoming a safer place not a more dangerous one. Once problems are recognized and begin to be dealt with, they're not as consequential anymore. A rag tag bunch of terrorists supported by a rag tag bunch of rogue states, no matter how zealous, are no match for the might of the U.S., let alone a coalition of the most powerful countries that even include former adversaries like Russia. It may take some time and some more disturbing headlines, but, like Nortel at $105, terrorism too has peaked. So will fanaticism everywhere be reviled and rejected. Religious moderates may be emboldened to assert themselves. Nervous governments such as in Egypt, Pakistan and Indonesia previously timorous of extremist elements may now be encouraged, if not to eliminate them, at least then to contain them. Even Arafat may now recognize that suicide bombing is no longer fashionable. Even he may be willing to risk reaction from terrorists rather than be seen to be one. Who knows, maybe some kind of peaceful coexistence between Israel and the Palestinians is finally possible. After all, who would have believed the Berlin wall would come down.

Our own country's lax immigration and refugee policies are being finally addressed. Politicians are mostly concerned with keeping their jobs and need a crisis to take extraordinary action. Apparently, next to the U.S. Canada has more terrorist cells than any country. Liberalism be damned, Chretien needs to address our misguided hospitality. In the U.S., President Bush has an approval rating of 92%, the highest of any President in history. He has finally found his voice and has the popular support to do whatever needs to be done to win the war against terrorism and to reverse the economic decline. Fiscal stimulus is high on his agenda. So will be, a policy to

lessen dependence on Mideast oil. And his new found popularity will overwhelm any opposition to his agenda. A pro business, pro stock market agenda.

Airport security will be improved. And in time, more quickly we think than generally thought, air travel will get back to normal levels. There's no doubt we all need a vacation now more than ever. The other day, despite FBI warnings of some undisclosed threat, 58,000 fans turned out in New York for the Yankee game. Terrorists are clearly no match for Yankee fans. The World Series goes on and so will the world.

Recovery Visible

If the bottom of the recession isn't at hand it's probably close. Look for maybe another three quarters of lousy earnings and recovery in the second half of 2002. The important auto industry is already showing some improvement with zero percent loans helping clear out inventories. And when inventories are depleted, production will need to be ramped up. Low mortgage rates should help move houses too. No big deal, a classic cycle. And earnings will recover too. Some reliable companies that have overcome their particular problems, like Coca-Cola, Johnson & Johnson and Philip Morris are already reporting satisfactory earnings. Who's surprised by disappointing earnings anymore anyway? Market expectations are so low that companies, like IBM, that just meet their depressed earnings expectations tend to rally strongly. But get ready for real positive surprises. Can you imagine how good the earnings numbers for the September 2002 quarter for the airline, hotel and casino industries will be compared to the disastrous September 2001 quarter just ended? And won't investors likely celebrate that.

As we have previously written, we have been concerned that final demand in the economy would stay weak: from tight government fiscal policy intent on maintaining surpluses; from weak business spending from an overleveraged corporate sector after a wild cyclical capital spending boom; and from weakening consumer spending from overleveraged consumers who are already sated with stuff. But the crisis has changed political sentiment to allow increased public spending for defense, security and economic assistance for beleaguered airlines and others. Tax revenues will decline yet tax cuts are expected to be implemented more quickly. Deficits are okay again and, guess what, the economy needs the stimulus.

As one might expect, business capital has been shrinking with plant closures and layoffs. Quebecor Printing closing 7 plants, Air Canada parking over 80 excess aircraft in the Arizona desert, and so on. Even if new capital spending were warranted it is difficult to finance. But this is a symptom of normal cyclical downturns and capacity utilization will eventually reduce commensurate with reduced demand to the point where they will be in balance so that when demand inevitably picks up so will capacity utilization and spending for additional capital stock. In the meantime, defense industries need to spend on capital. Lockheed Martin, winner of the huge new jet fighter contract, and its subcontractors will need to. So obviously will the New York City construction industry.

And many companies are using the crisis as an excuse for cost cutting, layoffs, restructuring and write offs, even though these might have been likely required in any event. But the effect will be a quicker road to recovery for reported earnings. As for consumers, whose spending accounts

for two-thirds of the economy, they're nervous and saving more. But as stuff ages and needs to be replenished, as savings increase, as confidence increases with U.S. progress in the conflict and belief that jobs are intact, the consumer will be induced to spend again, particularly as current low interest rates are a disincentive to save.

And the U.S. will need to put in place a "Marshall" type plan to help Afghanistan, Pakistan and other underdeveloped countries that are victims of the war or who have agreed to risk cooperating with the U.S. in the conflict. Not only will they be less threatening but as the standard of living of these countries improve, trade in U.S. goods and services with them will be enhanced. A significant aspect of the continuing war against terrorism will be to raise economic and educational standards wherever terrorism is bred. Eliminating terrorism means not only dealing with Osama bin Laden but educating the next generation that there's a better way through a better future in this life not just the hereafter. Life expectancy in Afghanistan is 47 years, one in seven children die in childbirth, the literacy rate in men is 27% and in women under 5%. TV is not permitted even if one could be afforded. Sound like a breeding ground for extremist views?

Time to Buy

So the bottom line is, the war against terrorism will proceed. There will be set backs but progress will be clear. The headlines may be scary at times. The economy will worsen, U.S. deficits will rise, unemployment may reach 6% and many companies will be bankrupt. Polaroid already is. Many other debt ridden companies may not make it. Others, like Air Canada, will need to restructure. But time heals all. And, as it always does, the economy will recover because the cycle of renewal will have run its course.

We believe the market has already reacted to all the bad news and maybe then some. And it's time to be fully invested in stocks. More than ever we still need to be selective because many companies will languish or disappear. But the survivors, who are getting leaner and meaner, will be stronger than ever, if only from diminished competition.

So we're avoiding companies with poor balance sheets. And companies where the worst is yet to come and it's not yet "in the market". Banks, for example, because we don't believe they have recognized yet all the loan losses they'll incur both from defaulting debtor companies and defaulting debtor nations like Argentina.

We'll make mistakes and in this unusually poor September quarter our results suffered from mistakes we made with AES, Baytex (whose debt is high but manageable) and Teknion, though all three should recover from here.

We want to buy strong companies like InterTAN that has no long term debt and lots of cash and in Radio Shack a solid business franchise that is more valuable than its share price would indicate. And Cryptologic that has no debt, $6 per share in cash, has a significant market share, is growing 25% annually and after subtracting the cash per share is trading at about only 5x earnings. It became controversial recently because of questions regarding the legality of its gaming operations in the U.S. which we believe are unfounded but have made the stock a

bargain. We understand the company opportunistically has been buying back its own shares in the decline. More for the guys who don't sell.

And Pan Ocean Energy, already a bargain, had more cash net of debt per share than its share price—giving us its valuable oil and gas assets free. Accordingly it just bought back 40% of its common shares for $0.60 cash per share plus a preferred share which will pay a 10% cumulative dividend based on a $2.40 redemption price. We only tendered a very few of our shares for clients who should have the 17% annual income from the preferred shares based upon the current share price. But after the buy back, the net book value per common share rose to about $7 and to even a higher net asset value. So it's even a greater bargain especially since the next few months should see dramatic growth in its oil production.

And Hurricane Hydrocarbons which is also one of the cheapest companies we own but is being tainted by the fact its operations are in Khazakstan. Hurricane has significant equity participation from Khazak groups influential with the government and is about to receive a $4 per barrel pipeline transportation concession for a large part of its production. The company generates huge cash flows and should be debt free again in the not too distant future after repaying the $200 million debenture it recently distributed as a dividend to its shareholders. At only 2x earnings this company is another bargain.

In the market debacle we were able to buy some great companies at great prices. Household name Viacom (MTV, CBS, Paramount Studios, etc.) which we already traded for a decent gain and AOL Time Warner, the owner of CNN, to which we have all, no doubt, become addicted since September 11. Its vast and growing cable, internet service and broadcast operations, we believe, are worth more than the current share price. The effect of higher costs from broadcasting non-stop commercial-free war news in the face of already weakening advertising revenues is obviously temporary. If anything, viewership is rising. Ours is. And if Coca Cola and GM are doing better so will their advertising budgets soon rise, to the benefit of broadcasters.

Kimberly-Clark remains a bargain. Another great company, safe and dependable and so cheap. It declined a bit too in September as its earnings growth suffered moderately but should recover smartly and should benefit from the decline in the U.S. dollar we anticipate. There's not much safer than a company that makes toilet tissue which will still be in demand even if the economy goes into a "D", maybe even more in demand.

We recently bought CAE Inc. after it had declined more than 50% from its highs in the aftermath of September 11. This is an excellent company trading at a very low multiple of earnings relative to the market and its own historic levels and deserves to be higher even if its dominant business for flight simulators temporarily softens. Moreover it has a defence component which will clearly benefit in the current crisis.

We still favour oil and gas stocks which are cheap and believe that what has proved to be constant rising oil and gas demand even during slowdowns will translate into higher commodity prices. Oil companies typically have a long development horizon and are unaffected by the short-term price swings. A U.S. policy of less dependence on Mideast oil should benefit the Canadian oil industry. And so a consolidation has been going on in the Canadian oil industry

with Americans recently acquiring Anderson and Canadian Hunter at significant premiums. It would seem buying the assets is cheaper than exploring for them. Canadian Natural Resources is a great and growing company which could itself be either an acquirer or acquired and Baytex, which trades at a big discount to its net asset value, could be taken out too.

Golds Are Compelling

One of our favourite groups is the Gold stocks. The invincible U.S. dollar which in light of U.S. vulnerability may seem less attractive as a safe haven should permit gold to reclaim some of its lustre as the ultimate currency. Moreover citizens of many of the less developed countries may wish to hold more gold in trinket form as uncertainty in their lives is increased by recent developments.

Production of gold continues to decline in light of low prices and high costs which make production uneconomical for many mines. Companies that may have hedged too much future production could be precariously disadvantaged if prices rise—putting in question the very production they need to deliver into their hedges.

Though commodities have generally been deflating, gold prices are about 10% above their lows and the group is one of the best performing groups this year correlating, as it should, negatively with the declining market. While the papers talk of deflation, inflation may be lurking beneath the surface as a result of heavy money printing by central banks prior to, but massively so, during the crisis. Gold is a hedge against inflation with a low opportunity cost.

Short term interest rates are now below the rate of inflation, a condition the Fed would normally regard as dangerous. And producer prices recently released were higher than anticipated despite the slowing economy. Many industries, like airlines will need higher prices to survive which their customers will need to pay. Insurance premiums are definitely going up. Competition will be lessened as capacity shrinks. The very positively sloped yield curve (i.e. long term rates more than twice short term rates) may be suggesting higher inflation in the future from excessive liquidity, especially in a recovery, and exacerbated by the effects of a declining U.S. dollar and strong fiscal stimulus.

Our principal positions are Franco Nevada, Gold Fields and Dundee Precious Metals Fund all of which offer good value.

Who's Bullish Now?

For the last two years we have been bearish, and short selling overvalued high flying stocks for clients who allow us. We were in the minority then, going against the view of the mostly bullish market strategists. It now seems most everyone is bearish, even many value managers, and once again we're in the minority, this time however as reborn bulls. The psychology is right and the valuations are attractive. Especially taking into account the lowest interest rates in more than a decade and the return to normalized earnings in the recovery we anticipate next year. And there's lots of cash on the sidelines, earning meager returns, which will fuel the new bull. Margin debt has fallen to almost half what it was at the peak in March 2000. More fuel.

The market's history is generally one of a series of ascending peaks and valleys. The peaks are when investors are euphoric and these have been good times to sell. The valleys, when pessimism abounds, and are generally a good time to buy. We're in a valley now but we think the worst is over. We'll have some pullbacks, one may even be beginning now. We might even go back and test the lows. But we're now looking through the valley to the day when we start climbing again. History is on our side. The economy usually recovers 6-9 months after the Fed starts cutting rates and they started 9 months ago at 6.5%. And the market usually starts to recover in the worst of the recession. It feels like the worst to us. The current crisis is the 10th crisis since the end of the World War II and one year after the last 9 crises stocks had a 16.4% average return. Indeed since we turned bullish on September 24 the market has moved up smartly.

Having said that, we temper our bullishness with the belief that in the post bubble world, GDP growth over the next decade is likely to be lower than the norms of the past decade and so will stock market returns likely be something under the long term historical 9% returns as compared to the double digit returns enjoyed since the early '80s. But picking stocks is what we do. And as we've been able to achieve superior returns in a bear market by picking good stocks we hope to continue to pick the right stocks in the friendlier environment we envisage.

So despite the news, or maybe because of it, we're more relaxed about the market than we've been for some time. Maybe we will even eventually be able to switch from CNN back to Seinfeld reruns.

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