

STICK TO WHAT YOU KNOW

We recently (April 10) issued a letter to institutional clients of our sister company titled "The Bear is Done" which postulated that the end of the stock market decline was at hand. We arrived at that conclusion based on some proprietary technical work we do and the positive monetary, psychological and valuation parameters recently evidenced. This conclusion flies in the face of the opinion of several market strategists we respect who believe, as intuitively we would have also thought, that more carnage is still to come, that economic weakness would create more havoc with earnings and stock prices and that maybe after another false rally, the decline would finally end only after many more torturous months.

As you well know, we have been bearish for a year and a half and it has helped us achieve positive performance when markets were coming apart. So reversing course is not an easy decision. But it's what our work tells us. It also tells us, however, that even though most stocks have made their lows, the corrective rally that started in early April is petering out and that the market could once again pull back, if not to test the lows, then at least to test investor resolve and get us all sufficiently nervous again to set up the next upmove.

But when all is said and done, we know that prognosticating markets is by no means science. There are too many unknowables. In poker terms, too many down cards.

How bad will the economy and corporate earnings get? How fast and how much will interest rates decline? Will that stimulate the consumer? And capital spending? Will central banks continue to provide liquidity? If so, will overly cautious commercial banks continue to make the required loans? Will the liquidity fuel inflation? What will that do to the overvalued US dollar?

In the end, prognosticating markets is a little science and lots of art. But we're not in the forecasting business. We're in the business of managing money, of preserving capital and getting adequate returns on it. Making money in markets shouldn't require that much general market prognostication. We believe we should just deal with the up cards, with whatever we actually know.

Well, what do we know? We know the markets got crunched. That the NASDAQ Composite Index at its low was down 68% from its high, a pretty healthy decline even from absurd bubble prices. And that many technology stocks are down 80%. Some even disappeared. More will. Now that's a correction! And we know the economy has slowed dramatically, that many consumers have lost a lot of wealth and more are getting nervous about losing their jobs. Some 1/2 million jobs have been lost in this economic decline so far. Jobless claims at the end of April were the highest since October 1992, the end of the last recession. We know April was a dreadful month for auto sales. Computer sales have also fallen off a cliff. We know that US productivity declined and average hourly earnings and producer prices were up, a harbinger of future inflation. We know that high energy prices and excessive money printing aren't good for inflation either. A slowing economy and rising prices. We know that's not a good combination.

But not all prices are rising. We know that the bubble economy and the bubble markets led to excess capacity resulting in collapsing prices of technology products and so capital spending is naturally declining in techland. For example, prices for bandwidth—the capacity to transmit data and voice—dropped 50% last year and could fall another 40% this year.

We know that in the first quarter there was a total of \$32 billion in corporate defaults compared to \$49 billion in all of last year. And we know the Fed Chairman knows this too and therefore orchestrated 4 interest rate cuts this year (including a surprise cut on April 10) with a fifth cut likely on May 15 and a significant increase in money growth. And we know that this liquidity will find its way into financial assets and is the main driver of the recent rally.

We have been bearish for some time and have believed the recent debacle was inevitable. But now we're getting more positive. While we don't know where the bottom is for the economy we know that remedial forces are finally at work. Inventories are being cut. Capacity is being reduced. Costs are being cut. Weak performers are being eliminated. And like in all cycles, even though the news may get uglier—more layoffs, more bankruptcies, and more hardship generally—each day brings us closer to the inevitable recovery. So we have to take positions to prepare for it.

And we know that markets tend to discount the future and typically bottom many months before the beginning of the recovery. They "climb a wall of worry".

And we know that as of March 23, the S&P500 was down for 8 consecutive weeks, a rate of decline not seen since the '70s and that panicky investors were capitulating.

And we know that valuations got a lot better, some even fabulous, as panicky investors in March dumped the babies with the bathwater. And it's the babies we want to own. And we know because our work told us that the decline into the lows of March 22 likely represented the worst so we should get fully invested in the babies.

How do we distinguish the babies from the bathwater? While many of the popular tech stocks may be great companies, their recovery may take longer than expected. Their presumed consistent earnings growth patterns of the past have been shown to be undependable, subject to cycles like other capital equipment providers; their ability to grow by acquisition using their shares as currency is now impaired; their ability to compensate employees with stock options rather than cash (which gets expensed) is affected; their customers' ability to finance with equity capital is gone; their own ability to finance customers' receivables is impaired, and their aggressive accounting practices are sure to come home to roost along with some class action suits. Why would we want to own what is fraught with so many things we can't know?

Moreover history has shown that the leaders in one bull market aren't necessarily the same in the next. Remember former leaders like Polaroid and Avon, two of the Nifty Fifty stocks of the bull market in the late '60s. They never led again. They barely followed. Bear markets tend to mark transitions from one group to another.

We are clearly in a technological and telecommunications revolution. But at what stage we are in it is unknowable and who the winners will be is also. Especially in this area where creative destruction merely takes hours. Investing in some technology stocks is like "Survivor", someone like Lucent is always getting voted off the island. The next Cisco could be two guys working in a garage like Messrs. Hewlett and Packard once did. Our objective as portfolio managers is to stick to what we know. We don't want to have to guess the survivors even if being right might mean extraordinary returns. It's not just about potential reward, it's about the attendant risk too.

So we are wanting to own good companies whose earnings and cash generation we know to be reliable, whose growth rates should continue, whose balance sheets are strong, whose price to earnings ratios are less than that for the market generally and, even better, their own growth rates, and whose prices are well down from their highs to valuation levels rarely reached, according to our work, except when being dumped with the bathwater.

The best of all of these are the "safe dependables", like providers of drugs, foods and necessities (like toilet tissue). Their businesses go on tickety-boo even in recessions. When they get cheap you want to jump on them. And when they get cheap, as now, paradoxically interest rates, as now, are usually lower making their reliable earnings stream even more valuable, almost as a proxy for fixed income.

So we recently bought Schering-Plough, a large pharmaceutical, best known for Claritin, its anti-allergy drug which accounts for 31% of its earnings. It's cheap even among its peers because of what we believe to be temporary regulatory concerns with its manufacturing procedures and allegations of unfair trade practices. Down from a high of \$60 and at only 19x next year's estimated earnings, growing in excess of 15% annually, we think it's a safe bet. We also bought Kimberly Clark (Kleenex, Huggies) another safe dependable stock when the price dropped on a temporary earnings glitch. It trades at 15x next year's earnings with an expected double-digit growth rate and superb profitability ratios. We're currently evaluating other safe dependables like Safeway, McDonalds, Costco and IHOP, waiting for entry points.

Sometimes we can buy great growth stocks that, believe it or not, have nothing to do with technology, like AES down 40% from its high. AES is a consistently fast growing (30% annually) \$25 billion electric power company which is rapidly expanding in the US, Latin America, Asia and elsewhere around the globe (but, thankfully, only 4% in beleaguered California) and which trades at only 20x next year's estimated earnings. The US is going to need five new power plants per month for the next 10 years and we know AES should be a significant beneficiary of that expansion.

Sometimes too, we're able to buy stocks relatively cheap for what we think is a trade, not necessarily a long-term hold. On this basis we bought and sold Gemstar-TV Guide for about a 20% gain. We also bought and sold Symantec for about a 40% gain. Symantec's computer anti-virus software continues to be in high demand despite the slowdown and it has a large cash position of about \$9 per share which we believe could be useful for acquisitions including of its own shares. While we were prepared to hold both of these stocks longer term, it seemed prudent to realize on the rapid gains they provided.

We continue to hold a large position in Cryptologic which has been very profitable for us. Despite the recent buyback of almost 1 million shares at \$19, the company still has about \$5 per share in cash and no debt, just reported higher revenues (up over 30%) and earnings (up over 25%) and should earn at least CDN\$2.25 per share next year giving it a price/earnings ratio of only 12x.

We continue to hold InterTAN which operates Radio Shack in Canada and which has engaged investment bankers with a view to increasing shareholder value, normally, a euphemism for finding a buyer. The Company recently sold its Australian unit, as a result now has US\$3.00 in cash per share, is continuing to grow its earnings in a difficult economy and trades at only 14x current year's earnings.

We recently bought Mosaic Group which provides outsourced marketing services to leading corporations in Canada, the US and Europe, after an unjustified steep drop in its share price. Mosaic has been a steady grower, well managed with excellent returns on invested capital and at the price we paid was only trading at 7x this year's cash earnings. Insiders were buying when we were buying and after just reporting a solid first quarter earnings number, the stock jumped up over 50% in the last few days.

Two of the cheapest groups remain the Oils and the Precious Metals and we're overweight both. Among the Oils we own Canadian Natural Resources, one of Canada's largest independent oil producers which is cheap at only 3x cash flow; PanAfrican Energy which has no debt and about \$2 per share in consolidated cash (equal to its share price) giving us a substantial amount of oil and gas assets free, and Hurricane Hydrocarbons, extraordinarily cheap at less than 3x earnings. Hurricane is currently in a dispute with its 30% Kazak shareholder which is bidding \$10.25 per share for an additional 20%, seeking to gain control, which may cause Hurricane to take steps to "increase shareholder value" (remember that euphemism) and put the company "in play" earlier than previously hoped.

We continue to overweight the perpetually unpopular golds despite the derision of our peers believing as we do that the overvalued US dollar one day soon will correct, that the liquidity currently being created could result in higher consumer prices and that as a result, gold, increasingly scarce, will be desired by investors again. Gold is a contrarian's delight. Indeed, the term "Precious Metal" has become an oxymoron. In the meantime, Franco Nevada, our largest gold position continues to perform satisfactorily. It recently exchanged its Ken Snyder Mine in Nevada and some cash for a 19% interest in Normandy Mines, the largest Australian producer (2.4 million ounces annually). Franco still has about \$1 billion in cash, is very profitable and trades below fair market value.

Dundee Precious Metals Fund, our second largest gold holding, still trades at about a 40% discount from its net asset value even though its share price is up about 25% recently.

With our current more bullish posture, in early April we reduced cash weightings and, for our hedged accounts, their short positions. More recently we have added a little to our short positions (Amazon.com, EBay, Manulife, Paraxel and Research In Motion) and trimmed overweight positions where we have large gains (e.g., Cryptologic).

All in all, we've had a very successful March Quarter and April performance was excellent as well. In fact, we've continued to perform well throughout a very poor market by not "playing the market", but by buying value and by sticking to what we think we know.

Randall Abramson, CFA

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