

## THE GOOD, THE BAD AND THE UGLY

Like the title of the Clint Eastwood spaghetti western, what's happening today in markets and economies could be categorized as being Good, Bad or Ugly.

Ugly was our performance in March.

In our last quarterly letter, we warned of the Ides of March, thinking it would be Bad for markets. And, accordingly, we have been defensively, bearishly postured. But those tricky Ides turned out to be not Bad for markets, only Bad for Saddam, and Bad for us too. Anticipating an obvious successful Coalition victory, many times over in fact, the market, in a big short squeeze, rallied overvalued stocks we and others were shorting, including even bankrupt airlines. At the same time, it sold off gold bullion and defensive gold stocks, crude oil and cheap oil stocks and ignored merely moribund value and non-market type stocks. Our Canadian dollar accounts also suffered from the hit to their valuation of their US stocks from the dramatic rise in the Canadian dollar. Though March was Ugly, there were no blowups of individual stocks. No "permanent impairment" as we say in money manager lingo. Just some overall crummy price fluctuation in groups and stocks that became temporarily unpopular or neglected as market participants, like giddy Iraqi looters, indiscriminately celebrated military victory.

We hate those Ides. We hate losing. Our job, foremost, is to preserve capital, and in that regard, we've done fairly well over the past 3 year bear market. We apologize for the March quarter. We're on guard to not let it recur. And we're not comforted that many other value and hedge money managers got "Ides'd" too. What's an Ides anyway?

But we're still bearish on stocks generally. Like the bigger, overvalued ones. *Yahoo*, *Amazon.com*, *eBay*—great internet companies all—but trading at ridiculously high valuations. And especially the ones we're shorting—*AMR*, *Delta Airlines* and *Four Seasons Hotels* because travel is as Ugly as can be; *Maxim*, *Cree* and *QLogic*, because they trade at excessive valuations, have run up quickly in the rally and are vulnerable if any hiccup in growth occurs.

As our clients know, we only short stocks heavily, as now, when our work suggests the overall market is more likely to decline than rise. Whenever we're short, we're nervously so, because (a) the risk reward ratio for shorts is not as good as for longs—you can only double your money on a short if it goes to zero, whereas your potential risk is theoretically unlimited; the risk/reward profile for a long is the reverse; (b) the market has an upward bias, most of the time it's rising; (c) these days, with 5,000 hedge funds in operation, many shorting the same overvalued stocks, a market upmove can result in a painful short squeeze, à la our March experience, and (d) the volatility of our short sales is therefore far greater than that of our longs, and we dread those painful temporary upmoves. Nonetheless, with our current bearish view, we believe some short-term pain will be worth the long-term gain.

We're nervous bears, also, because we could be wrong. The market has been going down for over 3 years and has come down a lot. After all, almost \$5.8 trillion has already been lost since the March 2000 highs, so clearly the cream may be off the top, so to speak.

And, we believe, at current low interest rates, the market is undervalued. We also see some modest improvement in corporate earnings as many companies meet expectations, though significantly lowered expectations. And we can't ignore the bullish prognostications of some very intelligent market watchers we respect: Don Hays, Barton Biggs, Christopher Cadbury and others. On the other hand, there are other equally respected Soothsayers who are bearish: Tom Peterson, Eric Sprott, Richard Russell, Stephen Roach, Ross Healy. Overall, however, we note that statistically there are still more bulls than bears, surprising after this much decline, which, as you may know, is a bearish sign, since markets typically bottom in a sea of pessimism. That's when Ugly is Good. But again we need to abide by our work. It is unique and has made mostly correct market calls, and if we're wrong, and the market rises through certain upper "break points" and gives us a "buy signal", we'll reverse course as quickly as we can. It is this process that has allowed us to outperform in the last three years. If it works again, despite a poor start to '03, we can still achieve a positive year.

Again, remember that we're always net long. And we think our core longs are excellent values. In fact, recently they've been performing fairly well (*Pan-Ocean*, *Hurricane Hydrocarbons*, *CryptoLogic*, *Newalta* and, recently, even *CAE*).

## **Good as Gold**

The group that we are long that gave us some considerable grief in the March quarter was the golds, which underwent a substantial correction. Our portfolios are heavily overweight the gold group for some compelling reasons:

- (a) Gold, and commodities generally, are coming off of a 20-year Ugly bear market.
- (b) The supply of gold, some 2500 tonnes annually, has for some years now, been exceeded by demand of 4000 tonnes, with the shortfall being met by Central Bank sales and lending and by producer hedging and "carry trade", much of which has been curtailed, and in fact, has created a dangerously oversized short position.
- (c) Gold, as a safe haven "currency", tends to move inversely to the direction of the US dollar, now in serious decline.
- (d) Some Central Banks, notably Asians (and particularly China, now the tenth largest holder of gold in the world), have been adding to gold as part of their exchange reserves.
- (e) With interest rates at 45-year lows, the opportunity cost of holding gold is low.
- (f) Disgruntled stock investors are moving funds into real assets like real estate and precious metals. At its 1980 high, gold traded at a 1:1 ratio with the Dow. Today, even with a depressed Dow, the ratio is only 1:25 allowing for considerable cyclical upside.
- (g) Gold and silver mines have for years underinvested in exploration and hi-graded their mines to stay afloat, keeping a lid on future supply.
- (h) Demand for gold from investors should increase. Some Muslim countries, led by Malaysia, have recently introduced a gold-backed currency, the Dinar, as a medium of exchange among them. China has recently allowed its citizens to buy gold and recently opened a Shanghai Gold Exchange with ordinary citizens soon to be allowed to trade.

- (i) Gold may be the ultimate beneficiary of a potential systemic blowup, say a dollar crash, a derivatives debacle, a deflationary or inflationary conclusion. Record deficits, budget deficits and loose money are a prescription for a weaker currency and more inflation. Gold is the ultimate monetary insurance and it is undervalued and gold stocks are underowned—the market capitalization of all the publicly traded gold companies is less than that of *Bristol Myers*.
- (j) Costs for producing gold, which is denominated in US dollars, are rising with the local currency in the countries that produce gold, such as South Africa, Australia and Canada, making gold less economic to produce and ultimately requiring higher prices to offset higher costs.

Accordingly, we hold an overweighted diversified portfolio of growing gold companies which we think represent good value especially if, over the next few years, bullion rises to the extent we suspect. These include *Gold Fields*, *High River Gold*, *Northgate*, *Rio Narcea*, *Cambior*, *Pan American Silver* and, in certain accounts, *River Gold* and *St Andrew Goldfields*. Whenever things go Bad, gold should be Good. If things get Ugly, gold should be very Good. A core position in gold is a must.

### **Unemployment Bad for Confidence**

The Iraqi war is over and that's Good. The Bad guys are defeated and Clint (read: Bush) saved the townfolk again. And Bad guys throughout the Middle East and in North Korea are getting more compliant now that Bush is clearly the fastest draw in town.

The victory for the Good guys, the drop in the price of oil as its war premium diminished and the celebration in the stock market have caused consumer sentiment to rise somewhat, from 77.6 to 86 in April. That's Good because consumer spending accounts for 2/3 of the economy. But we think the improvement in the consumer's sentiment will be short lived and that's Bad. Why? Because there are now over 8.8 million people "officially" unemployed, 2 million since Bush took office, and about 5 million people who have given up looking for work. Unemployment has just risen in April to 6% with both wages and hours worked slipping. Rising unemployment will restrain the consumer's mood and his willingness to spend. Some economists say unemployment is a lagging indicator. To which we say "lagging, shmaggng". When your neighbour's out of work, you're worried. That's Bad. For your neighbour, it's downright Ugly.

What's also a restraint on the consumer is the level of his debt. It is Bad. He's been financing much of his spending by refinancing the equity in his house at record low interest rates to dangerously high levels. Especially if rates go up. That's Bad. On the other hand, he's been increasing his savings to over 4%, which is Good, but still half of what it should be.

As for business spending, the other part of the demand equation, with capacity utilization at only 73% and weak pricing power (for example, the auto sector with 5-year zero interest financing and used car prices down 6%), the mood among business executives remains pessimistic too. Margins are poor as business is squeezed by rising costs and an inability to pass them along. That's Bad.

To be sure, a lower dollar will help US manufacturers compete, but Europe and Japan and now even the rest of Asia, SARS impacted and dollar impacted, will be overall negatively impacted. In other words, world economic growth is likely to be Bad.

## **Profitless Recovery**

In a low growth world, with margins squeezed, corporate profitability will be elusive indeed. Of companies reporting their first quarter thus far, some 62% have met expectations, but those were lowered expectations to be sure. Also, a big lift to reported earnings came from cost reductions or one-time gains, and even a lift to the top line came from the effect of the declining dollar. *IBM*, for example. Many companies that met expectations have expressed caution about the future. *Dell Computer*, *Microsoft* and *Cisco*, for example, see no signs of a rebound in the global economy. And overall S&P500 earnings have been supported by the unusually high energy company earnings. The ISM Manufacturing Index dropped to 45.4 in April, the lowest since October 2001.

Underfunded corporate pension plans, estimated to exceed \$300 billion, will be a serious drag on corporate earnings. That's Bad. Though, ironically, more contributions to pension plans may increase the demand for stocks and bonds which could be Good.

Since the performance of stocks is tied directly to corporate profits and since corporate profits, in the medium-term anyway, should continue to be lackluster, stock performance should logically be expected to be Bad. What's Good however, is that cost cutting and productivity improvements are making corporate America lean and mean so that whenever demand picks up, as it inevitably will, profitability may be mighty impressive. With help from a lower dollar to boot. But a profits recovery might not happen until 2004 or even later, and meanwhile, the market may disappoint. Corporate insiders must smell this. Their recent stock sales overwhelm their miniscule purchases.

Tourism is Ugly. Tourism represents 10% of all international trade and now, hit by economic concerns, terrorism, war and, most recently, SARS, the tourism industry is in a crisis mode. Layoffs and bankruptcies plague the industry. Profits in this area, from Vegas casinos, to cruise lines, to airlines, car rentals and hotels, have been dismal. We've been short *AMR*, *Delta* and *Four Seasons Hotels*, expecting the "inevitable" decline, but meanwhile suffering the short squeeze.

## **A Fistful of Dollars**

The US dollar is in decline. That's Good for US manufacturers and exporters as they become more competitive and for US multinationals, like *McDonald's*, which repatriate higher foreign earnings. Ultimately it should reduce the US trade deficit which currently runs at an unsustainable 5.5% of GDP. But, conversely, it's Bad for importers such as *Wal-Mart* and naturally for manufacturers in other countries that depend on trade with the US or which produce commodities denominated in US dollars. By allowing, or even encouraging the drop in the dollar, the US is exporting its slowdown abroad, to Europe and Japan which are already in a funk. Look for the Europeans, and maybe Canada, to lower interest rates to get their currencies down to help their domestic exporters. Leapfrog. Shades of the '30s. The declining dollar is also Bad for US financial assets as foreigners suffer large losses on their US holdings. Foreigners own over 43% of US debt and about 27% of US equities on which they lose when the US dollar falls. If the dollar goes into free fall, things could go from Bad to Ugly as foreigners dump US financial assets, especially bonds, a really Bad circumstance because US rates may have to rise to attract the \$2 billion per day required to fund the deficit. Forget bonds. Think gold.

## **Debt Levels - Bad**

US debt at all levels is Ugly. Though corporate debt is improving somewhat, consumer debt is Bad. But government debt at every level—federal, state and municipality—is Bad going to Ugly. The US budget deficit should exceed \$400 billion this year. California needs to borrow \$24 billion to fund its \$30 billion deficit. NYC is talking about laying off firefighters, police and health workers and is raising subway and bus fares. Bush may be seeking tax reduction at the federal level, but it will likely be offset by rising state and municipal taxes, all sorts of fees and college tuition and, especially, real estate taxes. Remember crowding out? Forget bonds. Think gold.

Worry about \$142 trillion of financial derivatives. Greenspan worries about them. Warren Buffett calls them weapons of mass destruction. Could be Ugly. Worry about housing if mortgage rates go up. Housing starts held up in March, but permits were down 7%. Housing sales are slowing. Personal bankruptcy rates and foreclosures are rising.

## **Trouble in Dodge City**

We have always relied on fundamental analysis as the starting point to stock picking. And relied on reason and experience to help us determine the likely direction of the economy, interest rates and the various asset classes. It would appear these days that normal relationships are out of whack. As the dollar makes new lows and stocks are rallying, bonds are at their highs—i.e., interest rates are down even as they should normally be expected to rise. We can only attribute this to some serious problem with hedgers on the wrong side of a bond trade, or to the work of Sheriff Greenspan as the Fed buys bonds and to the involvement of the Plunge Protection Posse (actually the “Plunge Protection Team” of the Treasury put in place to smooth markets) which likely have been propping up Stock Index Futures.

Sheriff Greenspan and his deputy, Bernanke, have openly stated they’re concerned about deflation and downside risks. And, so far, they’ve been “pushing on a string”. Twelve consecutive rate cuts without any real recovery. By buying longer-dated bonds, the Fed hopes it can stimulate the economy, keep liquidity high, mortgage rates low, allow the dollar to decline and add to inflation. Trouble is, Boot Hill is littered with the graves of Central Bankers and treasury officials who tried to avert the normal, powerful, invisible hand of economic and market forces which come into play. Sheriff Greenspan best be mighty wary of those Bond vigilantes. By buying bonds from the Treasury, the Fed is committing the ultimate act of currency debasement. Sell the dollar; sell bonds. Buy gold.

## **The Best in the West**

So what’s an honest gunfighter, committed to performing for his clients, to do? Well, overweight golds, for sure. And we do. Stay short overvalued stocks which are “on sell” in our SVA™ work. As long as the market itself is “on sell”. And if we’re wrong and the market goes “on buy”, then quickly reverse, reduce shorts and add longs. We’re a gunfighter with an itchy trigger finger, ready to move to avoid loss if a signal is given.

Currently, the Bad and the Ugly seem to outweigh the Good. The market is overbought and needs lower prices, to discount more of the Bad and Ugly and to reduce the risk of downside while the world inexorably adjusts from Bad to Good.

There is clearly some Good too. Generally speaking, it would appear that small and medium cap stocks are better value than big caps. Not an unusual phenomenon during the latter stages of a bear market. The biggest and best companies are the last to lose their popularity and need to complete their fall to earth as investors capitulate. That'll be Ugly to look at, but Good to buy into.

Good is *CryptoLogic* which just reported Q1 revenues and earnings ahead of expectations. At the behest of some larger shareholders, Randall has just been elected to the Board of Directors. We have much higher targets for this stock.

Good is *Pan-Ocean*, which recently announced it purchased its joint venture partner's interest in the Pan-African Fund on terms accretive to *Pan-Ocean* shareholders. It is now producing about 9700 barrels of oil per day, should cash flow about \$3 per share this year and can grow significantly going forward. We think the shares can double again.

Good is *Hurricane Hydrocarbons*. It just reported a record quarter and its volumes continue to grow with transportation savings to be implemented later this year. At less than 3x 2003 earnings, this stock should be valued substantially higher. At this low valuation, it is an attractive takeover target.

Good is *CAE*, which has given us our fair share of grief, but has just reported 2002 earnings of \$.60, a respectable performance in a bleak aviation sector. A Canadian technology success story with over 80% of the world's flight simulator business, a major flight training operator, with nearly half of its business in military, *CAE* is very cheap at 6.5x earnings. It should resume its growth and reduce its heavy debt load now that its training business capital spending program is essentially complete.

Good is *La Senza*, which is a simple business model selling low- to mid-price women's undergarments (real cowboys aren't embarrassed to own lingerie) through dominant corporate stores in Canada, is expanding into the US and successfully franchising elsewhere internationally. It has an excellent balance sheet, should earn \$1.50 this year, and with \$4 per share of other assets, the stock has considerable upside.

Good also are the potpourri of income trusts we own: *Calpine Power*, *Acclaim Energy*, *Sleep Country*, *A&W*, *Boston Pizza*, *Newalta* and others, which grind out respectable returns almost no matter the fluctuations of the market. We would have done better last quarter holding more of these in growth accounts.

Good is *Canadian Superior Energy*, which produces about 4000 b.o.e., mostly natural gas from its recently acquired Drumheller play in Alberta, and trades at about 4x 2003 cash flow. We're bullish on natural gas and the potential from this production. But the real upside here are the high impact plays from the drilling of a potentially significant discovery at East Ladyfern in Alberta and, with El Paso funds, the drilling of a \$45 million well offshore Nova Scotia this summer. Low downside, but huge upside potential.

This has been an unusually tricky period for money managers. A war, a victory rally, a dramatic dollar decline, and a series of asset class moves that don't make apparent sense, perhaps because of intervention or anomalous and unsustainable investor behaviour. For our part, we're staying with the tried and true fundamentals, buying what's cheap, selling what's expensive and embracing the logic of what's invariably the norm and what's intuitively right. If we do it right and use our timing work effectively, our clients will make money, we'll be vindicated, and like Clint, ride off into the sunset to find some other beleaguered townfolk desperate for portfolio management. With a stop at the saloon to try to forget March.

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