

ROLL WITH THE PUNCHES

It's an axiom that the market hates uncertainty. Stands to reason if the outcome is apparently uncertain, investors will sit on their hands, and their money. On the other hand, if everyone could clearly discern a certain outcome, they would all place their bets accordingly. Like on the favourite at the track. But then, of course, if most people are on the favourite outcome, it's "in the market", so the odds for a big payoff would be low. Whereas, a long shot surprise, positive or negative, creates an outsized payoff or loss. That's why, ironically, it's safer to invest when everyone's worried. Climbing the proverbial "wall of worry". What we do, in uncertain times, is roll with the punches and seek out distinct opportunities. We've said it before, there's always a bull market somewhere.

These seem to be unusually uncertain times. Not in respect of all matters, but for a great many of them. It's clear the US economy, indeed the world economy, is resuscitated. Oxygen from lots of monetary and fiscal stimulus—the lowest interest rates in a half century, the unusual growth of China and India and their stimulative demands, a productivity revolution from modern technology and cost cutting—all did the trick and saved the patient. The result: improved GDP growth (up 4.2% in Q1), improved employment conditions (288,000 new jobs in April) and improved corporate profitability (up 29% year over year). Five out of six companies reported Q1 profitability that exceeded estimates, the best record in a decade. Important companies too. Disney, Ford and Hewlett Packard, for example. Housing continues strong. Auto sales are holding up and retailers generally are doing well. Manufacturing output is stronger. Margins are finally improving. The US dollar has rebounded, and conversely, its nemesis, gold, has declined. So far, so good. Don't worry 'bout a thing. 'Cause every little thing's gonna be alright.

Interest Rates

But there are some wild cards. We continue to focus in each letter, ad boredom, on the growing US national debt, the dependence on foreigners to finance it, and particularly on the excessive amount of consumer debt and the consumer's vulnerability to rising interest rates. If mortgage rates keep rising, will the housing market tank? While the US budget deficit may be lower than forecast on account of higher tax receipts from a stronger economy, down to, say, a mere \$400 billion, what might be the impact of higher rates, therefore higher debt service, on the mountain of debt that needs to be serviced in an economy, in turn, slowed by higher rates? The recent better employment numbers and modest change in language from the Fed about potential "measured" increases in rates has caused bonds and stocks to drop and the US dollar to rise, negatively impacting consumer sentiment and the trade deficit. But there's some skepticism from analysts about the reliability of the positive jobs statistics that were reported recently.

And, hey, if rates go up in an overleveraged economy so sensitive to rates that it slows it, maybe materially, won't rates just go back down again? Then too, even if rates go up ¼ point in June, haven't bond markets already factored in the rise? Uncertainty. But important. Nothing, repeat nothing, is more important than interest rates. For affordability and valuations and currency attractiveness.

Flation

The direction and level of interest rates is not only governed by the strength or weakness of the economy, the concomitant demand for money and the policy responses of central bankers to assist or retard growth, but very much by the rise and fall of prices. Lenders will refrain from investing long term if they're likely to get repaid in deflated dollars. And central bankers will print money to avoid deflation and tighten to stop inflation. The Fed has for some time now been concerned with deflation, fearing an outcome like Japan. And conspired too to lower the dollar. Recently, however, US April Producer Prices (up 0.7%) and Consumer Prices (up 0.2%) have been rising; commodity prices, including oil, are strong and producers seem more able to pass along costs, increasing their meager margins and raising prices for consumers. Short-term interest rates currently generate negative real returns and the exceedingly positively sloped yield curve reflects the outsized compensation longer term lenders require to offset the rising inflation risk. Consumers are encouraged to borrow and spend in an inflationary environment, and spending they are. Of course, savers would get better returns from rising rates with which to spend more too. Central bankers usually don't like inflation and raise rates to discourage it. But, in an overleveraged economy, if they do, they'll surely slow it up. A trap. So money supply is growing apace (M1 up 15% annualized). And one uncertainty removed, its 78 year old purveyor, Fed Chairman Greenspan, who adroitly steered us from burst bubble to recovery, has been reappointed for another term. Adjusted for inflation, he thinks he's only 47. Uncertainty.

What kind of 'flation will we have? De', in' or stag'? We're not sure, but we know if they're buying Picassos for a record US\$104M and an average Manhattan apartment costs US\$1M, the psychology for asset inflation is upon us. The reality is some assets, like Picassos, are inflating while others, like computers and telecommunication costs, are not. But, generally, prices paid and received by businesses are climbing at an unusually steep rate.

We might be in for stagflation—slow growth and rising prices. A difficult job market. In the US, nine million people are still unemployed. High oil prices are at once inflationary and a tax on consumers. Moderately rising interest rates (and higher consumer prices) will dampen affordability; bankruptcies and delinquencies will rise; personal incomes won't keep up and fiscal stimulus will diminish as government spending is reduced to combat rising deficits. We don't think interest rates will rise materially. They can't. In fact, bonds look set to rally. Nonetheless, we avoid medium to long-term government bonds. The rewards are puny, and after a 22-year bull market in bonds, the risk of capital loss is too great. Rolling with the punches, we think quality income trusts are okay. They may be Canada's equivalent to US TIPS, inasmuch as they yield 7-13% and are somewhat hedged against inflation. If prices go up, so may the returns from many of these trusts because the prices of what they sell will also be rising to offset their higher costs and to allow higher distributions.

In that environment, equities will be better than bonds. They most often are. If rates stay down, equities will be relatively attractive, and if rates go up, it'll be on account of a better economy or higher prices, better for equities. On an after tax basis, capital gains from equities are treated far better than interest from bonds. Oils, precious metals and commodity stocks should do well. So should the currencies of commodity producers like Canada and Australia.

Geopolitical Risks

Lots of uncertainty in this area. An expensive presence in Iraq (\$200 billion thus far and an ongoing \$5 billion a month), which should diminish after political turnover in June. A continuing and prolonged fight against terrorism which, there's no doubt, will be costly, but, we firmly believe, ultimately successful. Nuclear threats, from Iran and North Korea. Though, on the other hand, progress with Libya. And better relations between India and Pakistan. Sanctions against Syria, headquarters of terrorism. New left wing governments in Spain and India, potentially less friendly to US interests. Prospects for Middle East peace elusive. A less stable Saudi regime and, therefore, less reliable oil production.

At home, political uncertainty in an election year. Bush is, for the moment, less popular and Kerry as President means higher taxes and policies less friendly to Wall Street. A potential minority government in Canada. Renewed deficits in Ontario.

In an effort to slow inflation (3.8% last month) and to moderate growth from its current 9.8% to 7%, China has increased bank reserves and limited lending to certain industries, spooking markets that recall the Asian contagion of 1998. The Japanese market and the yen recently got hit as Japanese machine orders dropped. The Japanese are serious exporters (especially of capital goods) to China.

Japan and China, with massive foreign exchange reserves from massive trade surpluses, have cut back on their buying of US treasury bond issues, formerly intended to prop up the US dollar. They apparently want to diversify their foreign exchange reserves. Fewer dollars. Maybe more gold? What are the implications for US interest rates and the US dollar? Last week's 10-year tranche of treasuries saw the Fed buy \$2.9 billion of the issue. Were the foreign buyers absent? Uncertainty.

The World is Our Oyster

Markets hate uncertainty, but there's lots of liquidity out there and it's going to go where it's treated the best. Stocks, bonds or cash. US, Canadian or foreign. Long, short. Financial assets or tangible assets. Commodities. Real estate. Collectibles. Buffett is sitting with \$36 billion in cash because he can't find good value, and at year end, he was \$12 billion invested in foreign currencies, more since then, for the first time ever. John Templeton and George Soros concur. Three heavyweights for sure. Buffett's got a massive hoard of silver too. The world is his oyster. He can roll with the punches. Bob, weave and defend himself. Or look for an opening for a good punch, maybe a knockout punch.

The other richer guy, Bill Gates, is more limited. Microsoft is his main oyster. And though he sells down regularly to diversify, he can never move as adroitly as the second richest man to put his money where it will be treated the best. We think that, over time, Buffett's opportunity advantage will allow him to gain the title from the current champ who's handicapped by his concentration in merely one marvelous equity.

We think we, and our clients, are fortunate too. The world is our oyster, and we intend to go where money is treated the best, to bob and weave and duck too, to stay out of harm's way and to score occasional points with jabs and maybe land an occasional knockout punch. We mostly seek and have the advantage of a broad mandate. We can be long cheap equities of any kind, in any place, whenever propitious, and, for clients who allow it, short expensive ones to hedge, especially if we don't particularly like the broader market. We can be in golds or in oils. And we're currently in both. In cash, higher yielding corporate bonds or in income trusts. We can invest in Canada or the US or Japan or wherever.

Like Buffett over Gates, we have a major advantage over dedicated specialized funds like those limited to gold or oil or technology or money markets or emerging countries. Their managers are hopelessly handicapped and confined. Stuck when a correction in their group is upon them. Their unitholders have to make their own periodic, usually amateurish, decisions about moving from fund to fund, from class to class, from asset to asset. They better be able to take a punch. Especially those with "glass jaws" who are overleveraged or excessively concentrated.

A Fight Without End

We never can understand how certain pundits know where we are in a market cycle. The Dow Theorists, the Elliott Wavers, the Fibonacci numerists, the astrologers, the economists and other soothsayers can all seem to divine it. Is this merely a rally in an ongoing bear that will resume its downtrend to new horrifying lows, as some believe? To a ninth round knockout. Lying on the mat, like in 1975, with single digit P/E ratios and dividend yields higher than bond yields. Or, as suggested by others, have we seen the lows and will we be recovering to new market highs? Only the third round. There are so many unknown variables which affect the outcome. Buffett himself always says it's a mistake to bet against the economy. And Greenspan has said he wishes he had been Fed Chairman during the '30s to avert the depression. He's getting his chance. And sometimes, for markets, bad news is good news. Uncertainty is okay too. They keep interest rates low. The key to valuations. So we're agnostics. For us, the market fight is a continuum with an unlimited number of rounds. Because we're able to roll with the punches, we think we'll continue to win more rounds than we lose and stay ahead on points. That's what active money management is about.

Though we lost a couple of rounds in March and in April, from our corner, things look better. We see an opening.

With all this uncertainty, and stock and bond markets recently on the ropes, with many gloomy predictions to boot, we've recently turned more positive, reducing our cash and short positions, and increasing our equity long positions. We base this on our SVA™ work, which suggests that we've reached important support levels, and on the technical underpinnings of the market which have significantly improved. Investor sentiment is bearish, significant new lows are being made—a bottoming indicator—buying by corporate insiders is increasing, always a positive

signal. Bonds should rally after their large decline (after all, US mortgage applications were down 11.9% last week); after a record trade deficit, the US dollar should resume its decline (a benefit to earnings of multinational companies); margins should improve, therefore, so should corporate earnings. Even if the Fed raises rates, of necessity, it will be gradual and marginal at best; it is likely “in the market” and is not likely to harm the economy or valuations materially. Moreover, bond rates have already moved up in anticipation. The Fed won’t do anything material in an election year and is still concerned about the recovery and concerns about the trillions in derivatives and the exposure of the large government-sponsored mortgage agencies.

Contenders

Best of all, we’re finding good stocks to buy at attractive prices—like the five US companies we’ve recently added: *Nextel*, *SanDisk*, *UTStarcom*, *Conexant*, *Liberty Media*. These all have similar attributes: they are all leaders in their fields, growing rapidly and trading at bargain prices. They’ve all just fallen with the decline in the overall markets and overreactions from misperceptions about them (potential competition and lower margins).

Nextel, which we’ve owned before, is the fourth largest cell phone operator in the US. The company trades for about 13x next year’s earnings with revenue growth of 30%—EPS growth even higher. The company has the highest revenue per user in the business, a remarkably low churn rate and a packet-switched (read high software content) network which keeps their costs well below others. It also generates \$2 billion of annual free cash flow, virtually unheard of in the cell phone business. Our Fair Market Value (FMV) for NXTL is about 60% above the current share price and increasing.

SanDisk is a leading supplier of flash memory data storage for digital cameras, USB drives and cell phones. The company has tremendous intellectual property which allows it to collect significant royalties from competitors and suppliers, on top of its own product revenues. Sales and earnings growth have been remarkable—industry growth forecast to be 40% plus for years to come. SNDK has over \$6 per share of cash and no debt, and our FMV is about 55% above the current price and increasing rapidly.

UTStarcom provides cell phone handsets and wireless infrastructure, plus standard wireline equipment to telecom service providers. Its key market is China (the largest cell phone market in the world), where UTSI is the largest wireless handset provider. The company’s systems are lower cost than competitors and therefore have sold extremely well in China, India and other emerging markets. The company has almost \$3 per share of cash, net of all debt, is growing well in excess of 20% per annum and trades for merely 13x forward earnings, also well below our FMV.

Conexant is a semiconductor manufacturer specializing in chips with a broadband digital home theme, i.e., for DSL lines, satellite set top boxes and PC modems. The company was formerly spun out of Rockwell International and just completed a significant merger with Globespan. Both CNXT and Globespan were profitable companies in their own right, but together make for a potent combination of resources, technology, scale and market positioning. CNXT itself has spun out three separate companies with a fourth spin-out (Jazz Semi) due any time. The value to CNXT of the spin-outs plus the cash on the balance sheet is greater than the company’s debt. The company trades for 11x forward earnings (its peers trade at 18-30x) with an expected growth rate above 20%. CNXT could double in the next twelve months as this valuation

discount should decline in a reasonable tech market. In fact, a doubling from here would still put it slightly below its high of this past March.

Liberty Media is a collection of private and public broadcasting/media holdings run by John Malone, one of America's shrewdest cable broadcasting executives. Liberty has a net asset value more than 50% above its share price and the company seems to be taking steps to clarify its structure and narrow the discount. In the meantime, the asset value continues to grow as assets like News Corp., InterActive Corp., QVC Home Shopping and the Discovery channel are increasing in value.

Bottom line for us is: very cheap stocks are always "contenders".

Because we think the Canadian dollar can rise against the US currency, where we can, in Canadian dollar accounts, we're running US dollar margin debits for recent US purchases against offsetting Canadian dollar credits, to neutralize any negative currency impact.

In Canada, we're buying *Saskatchewan Wheat Pool*, *La Senza*, *Kingsway Financial* and will add to the income trusts after their current correction. We think the golds have had their correction and we continue to be well invested in this group with *Gold Fields*, *Cambior*, *High River* and *Etruscan*.

Oil prices are probably going higher as growing demand outstrips production. We continue to overweight the oils with very cheap *Petrokazakhstan* (6x forward earnings), *Pan-Ocean* (4x), *Canadian Superior* (half our appraised value) and some select, cheap and prospective Canadian producers like *Real Resources* and *Rally Energy*.

Perhaps, in due course, after things appear certain and markets have risen to fully reflect a better mood making valuations less compelling, stocks might look wobbly to us. We think then we'll probably, again, roll with the punches and get more defensive. Reduce longs. Increase shorts. Maybe even buy bonds and sell gold, like in 1982.

In the meantime, we think our clients, from their ringside seats, expect us to "dance like a butterfly and sting like a bee" to minimize loss and achieve satisfactory, positive returns. All we want is to make sure, come what may, we live to fight another day.

Herbert Abramson and
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