Good Stress

The late Dr. Hans Selye, eminent McGill University professor and founder of The International Institute for Stress, postulated that not all stress is bad. Indeed, some is good. Bad stress, no doubt, includes loss of a loved one, divorce, illness and unemployment. Also, investing in *Enron, WorldCom, Nortel, Lucent, UAL, GM, Ford,* and many former blue chips that are now wallpaper or merely junk. Talking about blue chips such as *IBM, AIG* and *Kodak,* the New York Times recently commented, "These onetime corporate titans have left shareholders as blue as their chips."

Good stress is preparing for the wedding (except in the case of runaway bride, Jennifer Willbanks), studying for final exams and labour pains. Also, holding undervalued stocks where analysis foretells the overwhelming likelihood of significant long-term gains notwithstanding some short-term pain from market declines. Personally, we prefer labour pains.

As professionals we know that corrections are inevitable. Markets fluctuate. There has rarely been a year since we've been in business that we haven't had 2 or 3 consecutive down months. We often anticipate these corrections and ameliorate the "drawdowns" through a combination of short selling, reducing weightings and/or raising cash. No matter, we still seem to suffer temporary reductions in portfolio values. But not permanent impairment. While we're never happy with them, "corrections" are just that. Tonics for temporarily extended markets to get back to healthy values or merely to technically stronger conditions.

The Four Step

As value investors we are on the constant lookout for opportunities to buy low. Bargains. We believe the real money is made in the buying, not the selling. So when markets correct and stocks that we prize get even cheaper, all things being equal, we cherish them even more. An opportunity for new money to add at lower prices. But for those already fully invested, a stressful drawdown, despite the fact that already attractive portfolios are even better value and accordingly lower risk. Realistically, any stress now should be regarded as good stress—after all, it derives from a lower risk portfolio with much better potential for gain when the correction inevitably ends. And end it will. They always do. Other than one starting in 1931, there has never been a 10 year period for the market that wasn't higher than the outset. Markets have a secular upward bias. Populations grow, economies grow, businesses grow, wealth grows, and, therefore, stock markets grow. With intermittent corrections, some more severe than others. A perpetual dance. The old four step. Three steps forward one step back. Occasionally two steps back.

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At Strategic, we have some pretty experienced dance instructors. Tripping the light fantastic are the old pros, Bill Moore, Don Carlisle, Bryan Rakusin, Lorne Graham and Herb who, despite failing memories about some things, remember vividly the one or two steps back in '69/'70, '73/'74, '77, '81 and thereafter. And the now 23 year bull market in bonds that started in 1982 when risk free long-term bonds yielded 18% in Canada. Our adolescent ballroom dancers, Martin Braun, Richard Hermon, Dave McCaslin, Gil Levinson, and Jack Hayden, recall also the crash of '87—a quick and ungraceful two steps back with a record dipsy doodle. The rest of our more youthful disco dancers, Mike Ostfield, James Bowen, Jonathan Wiesblatt, Anthony Visano, Adam Abramson and Randall, recall the recession of '90 and the Asian contagion of '98 and the bursting of the bubble in 2000. Tango hell. Fred Astaire's got nothing on us. Though he'd have recalled 1929.

Irrational Stress

But while we're experienced professionals and can handle those steps back, some of our clients can't. Some fear that the losses will continue indefinitely. Irrational stress…

Despite the fact that we rarely use leverage, that we are reasonably diversified, and best of all, that we own a potpourri of good businesses, all undervalued, all with the prospect of growing earnings and having little or no debt.

Despite the fact that real interest rates across a flat yield curve remain relatively low making fixed income as an asset class less attractive than equities. Indeed, Bill Gross, managing director of bond fund giant, PIMCO, thinks US 10 year treasuries, currently yielding 4.09% will yield between 3% and 4.5% over the next three to five years. Not much competition for stocks.

Despite the fact that real estate is generally overleveraged and over-owned and prices are in orbit making it less attractive as an asset class than equities. Though continuing low mortgage rates may not deter overpriced house buying.

Despite the fact that the majority of companies reporting earnings in the first quarter reported higher than analyst expectations. Better earnings and low interest rates make equities a desirable asset class. Corrections or not.

Despite the fact that we are heavily overweighted in gold stocks which have tended to correlate negatively with stocks generally, though not in this step back when stocks generally have corrected. Golds among the most. But if interest rates stay low, the opportunity cost for holding gold is favourable.

Despite the fact this market decline has behaved very inefficiently; that is to say, things that normally correlate haven't. Low long-term rates in the face of rising short-term rates are a "conundrum" to Fed chairman Greenspan. Hedge funds that normally make money on the way down with their shorting mandate have generally had negative returns for the year. Maybe the inefficiency is being caused by the proliferation of leveraged hedge funds who have lots to liquidate when they're caught offside. Good stress if you recognize the opportunity.

Despite the fact that we are heavily overweighted in oil and gas stocks, commodities that should stay relatively strong even in an economic slowdown. You gotta get to work and you gotta heat your home. So demand should be less elastic.

And despite the fact that, the market be damned, from a bottom up basis, we own cheap companies that will do very well over time and whose success will ultimately be properly reflected in their fair value prices. Warren Buffett has said when he buys companies he could care less if they shut the market down for 5 years. Right now we'd settle for 5 months.

Wall of Worry

Stress also derives from uncertainty. And there are currently a great deal of uncertain outcomes and divided expert opinions:

Is this merely a correction in a bull market or the start of a new bear market?
Will the Fed raise rates too far and choke off growth?
Is inflation picking up or will deflation reassert itself?
Are commodities peaking?
Will the China boom continue?
Is there a housing bubble, and if so, will it burst?
Will oil run to $105 (Goldman Sachs' forecast) or fall to $30 (Steve Forbes' forecast)?
Will GM and Ford fail?
Is the US dollar decline over or will a currency crisis ensue?
Is the economy slowing as indicated by some statistics (consumer confidence, industrial production, capacity utilization, inventory building, leading economic indicators, real wages, a flattening yield curve), or improving (housing starts, tax receipts, retail sales, non farm payrolls, trade deficit, US dollar strength)?
Who will form the next Canadian government?
Will the Canadian dollar decline as manufacturing slows or rise on the strength of Canada's resources?

There are strong opinions on both sides of all of these issues. And, we have our own. However, for us to achieve positive returns for our clients, the outcome of many of these questions may be mostly irrelevant. We tend to be bottom up investors—stock pickers—rather than top down market soothsayers. We want to own stocks that will prosper in any reasonable outcome. Sure, we'll do that much better with our oil and gold stocks if the prices of oil and gold rise, but we intend to outperform over time nonetheless, even if oil and gold decline somewhat. Because the stocks in these groups should, by growing production, still enjoy growing cash flow and earnings and multiples of these should expand from current undervalued levels.

There sure is lots to worry about. But, remember, bull markets like to climb "a wall of worry".

Interestingly, successful market operators have tools to measure stress levels and pessimism—VIX indicator, McLellan Oscillator, put-call ratio, ratio of advancing to declining stocks, new lows compared to new highs, on balance volume, odd lot short selling, specialist short selling—and when the stress and pessimism is the greatest—when "it's all in the market", when investors are bailing out and getting into cash, is the time the best buys are made. And, by the by, cash on the sidelines is some US$4.5 trillion earning diddly. Wallflowers waiting for a dance.

So, contrariness in market investing, to a point, is good. Buying when things look the worst is good. And when you know the fundamentals are improving, while the stressed out sellers are dumping indiscriminately, you have an advantage.

We even have our own indicators of when we're near the bottom. Of course, first and foremost, our own SVA™ work, which indicates important support levels. And which is telling us, for example, our gold stocks have bottomed. But also our proprietary contrary indicator, the "Strategic Fear Index", that is triggered when we get calls from certain clients who we know to be most anxious right at bottoms. And we're getting them now. We tell them we don't own anything that isn't cheap and improving. Whether it's our oils, our golds, our *La Senza* or our *Kingsway.* But they're still stressed. Bad stress for others is good stress for us. Isn't it common sense that one should be less worried when risk is diminishing because cheap stocks are even cheaper. But, as John Templeton has said, "When it comes to investing, common sense is an uncommon thing."

The markets reverse when the selling ultimately abates, sometimes with capitulation from all that stress, and then can recover, often quickly, on low volume. No bell goes off at the very bottom telling you when to buy. Just lots of little bells on the way down reminding us of continuing cheapness and that with each passing hour we're closer to the inevitable reversal.

Black Gold

Oil stocks represent a large portion of our portfolios. And, we believe that higher oil prices lie ahead. If not in the next few months, over the next few years. Oil demand will increasingly outweigh supply, exacerbated by increasing demand from fast growing developing countries and by declining supply as material discoveries have been virtually nonexistent.

OPEC is running full out, the Saudis are scrambling for rigs, the multinational oil companies aren't able to increase their reserves (several are actually declining) and are therefore buying back shares and paying dividends rather than boosting exploration expenditures. Although President Bush is proposing an energy bill with incentives for new refining capacity, encouraging alternative fuels and increased exploration, this takes time. Lots of time. Consumption may be tempered as prices move up, but not enough to offset an expected production decline. Hybrid vehicles and the increasing prevalence of alternative fuels are coming, but shouldn't have a meaningful effect for several years.

In the meantime, supply is not keeping up with demand. And, it's very likely to get worse. World oil discoveries peaked in the 1960s. And, oil production in many regions has been on the decline for years (the US peaked in the early '70s, the North Sea in the late '90s) and global production is now likely peaking, if it hasn't already. Geophysicist, M. King Hubbert, correctly forecast in 1956 that US production would peak and then commence to decline in the early '70s. Based on Hubbert's theory for reserve oil, production stats and new discoveries, other experts have projected for some time that world production would peak in the next couple of years. Worse, once the peak is reached, global production is projected to decline rapidly for many years to come. It's unlikely any of the experts forecast the demand side accurately. Last year global demand grew by 2.3m barrels per day which was the highest increase in 25 years. Nobody could have foreseen the remarkable growth from China, India and other developing countries. China is showing no signs of letup—oil imports rose over 20% in March. Also, with about 3.6 billion people in Asia, the region uses over 20m barrels of oil per day compared to US usage of about

22m with less than 10% of that population. Demand cannot help but ultimately eclipse supply. Even if Asian growth were to slow, we still have the problem of dwindling production.

Lest you believe that a recession could slow oil's rise, investment guru, Jim Rogers, reminds us that in the '70s when the economies of the US, Europe and elsewhere softened, the price of oil rose 15 fold. Moreover, he explains that the world's largest oil discoveries, but one (the Caspian Sea), were made over 35 years ago. Oil fields deplete and the naysayers aren't explaining where the oil will come from to lower prices and keep them down. He believes total demand has already surpassed supply with 84m bbls of demand and rising versus last year's production of 83.5m and falling.

And, for all the attention on Canada's oil sands, the output will likely only be enough, in a few years, to meet Canada's domestic needs. At the same time, the oil sands require increasing amounts of natural gas to get the bitumen from the ground putting further pressure on gas markets.

Nonetheless, energy prices could remain temporarily under pressure over the next couple of months. Inventories have grown and the US Strategic Petroleum Reserve is nearly full. Though, with the onset of the summer driving season in July, the start-up of China's Strategic Petroleum Reserves in August, the potential for a warmer or even normal summer after three mild ones in a row and the projection of global demand of 86m barrels per day of demand versus only 84m of supply by the end of this year and into 2006, we are likely to see higher pricing soon reassert itself. If energy expert Matthew Simmons is correct, we could even suffer a serious supply shock. Commenting on Saudi Arabia, he said, "We could be on the verge of seeing a collapse of 30% or 40% of their production in the imminent future, and 'imminent' means sometime in the next three to five years—but it could even be tomorrow." Other disruptions could occur in politically unstable places like Nigeria, Iran, Iraq, Indonesia and Venezuela. And, of course, as prices move lower, count on OPEC to cut back production to keep it from falling.

Oil Correction

Our oil and gas stocks performed very well through early March with the improving underlying fundamentals at each company. None of our positions even came close to achieving our fair market value targets. Since then, not one of our holdings has announced any material adverse change in their fundamentals and oil prices have remained around $50. The recent price declines of these stocks have been based merely on a negative shift in sentiment, mainly impacting the smaller oil and gas companies. The sector, weighted by the larger companies, remains near highs and "on buy" in our work.

We did recognize that the group was getting overheated, and accordingly, we could have taken some profits in our oil and gas positions earlier in the year and be repurchasing now at lower prices. But, we decided to hold for a number of reasons, including: the tax implications and transaction costs of selling and repurchasing; the inability to sell a few newer holdings that were subject to private placement hold period restrictions; concern about selling stocks where we still see enormous upside; in some cases a lack of liquidity to easily exit the positions, but, most important, the likely inability to reestablish the positions in what we think is merely a blip of a correction in an ongoing bull market. We did, however, hedge somewhat by short selling a couple of oil stocks, Blackrock Ventures and Nexen, that we believe are overvalued.

Short-term bull market corrections are tricky to react to. In an all-out bear, we can invest in non-market type stocks less correlated to the overall market, short sell aggressively and, of course, dispose of positions outright with a high confidence we'll buy them back cheaper. In a bull market though, we do not want to lose extraordinary positions in an attempt to avoid short, shallow corrections—as stressful as it may get at the time. Despite the current correction, we still believe oils are in a bullish phase. In general, the stock market remains a buy in our work having bounced from lower support levels only just returning to those support levels recently. Moreover, the North American markets are very undervalued at current interest rates and are at a 30% discount to our fair market value. But, in the end, we're more focussed on the market for our stocks than on the stock market.

Though higher energy prices are the icing on the cake, the oil companies we own should prosper, even with moderately lower oil prices, mainly through significant reserve growth from development drilling—that is to say, where the oil or gas is already known to exist as opposed to having to be discovered by wildcat exploration. Many of these are smaller companies with international assets and are generally underfollowed and unknown by the investment community, which is why they are bargains.

Pressing the Bet

As money managers who profess to diversify, why so much *Pan-Ocean*? None of our other individual holdings in growth accounts exceeds about a 5% portfolio weighting.

Herb calls it going for the jugular. Which doesn't mean coming after the money managers should the position not work out. That's bad stress—for us. It does mean, that when you find something as exceptionally prospective as we've ever known and with so little risk, we want to have a concomitant overweighting.

Currently at $25Cdn (from a recent high of $34), Pan-Ocean has a net asset value in the mid $30s based on a constant forward oil price in the low $40s per barrel. The company has the ability, based on oil already discovered, to ramp production from its current 10,000 barrels per day to over 30,000 during the next three years. We know the management team well and have great confidence in them. The company also has a very clean balance sheet with US$40 million of cash on hand. Cash flow of US$.53 for the first quarter was double that of the previous quarter.

The upside is substantial. At a minimum, we believe that the company will be generating enough earnings, even at mid $30 oil prices, to be worth 50% more than today's price in 18 months and twice today's price by the end of 2007. At $44 oil, those potential gains become 120% and 300% respectively. Using the $77 oil forecast of Jeff Rubin, economist for CIBC World Markets, Pan-Ocean would nearly earn its current share price in 2008 producing an outsized gain. The company has only scratched the surface of its properties. On the prolific Awoun permit, only 20% of the concession has been accessed thus far. Furthermore, our forecast does not include the potential from the free cash flow the company will throw off as all of its earnings will essentially be available for reinvestment, acquisitions, dividends or share buybacks.

Bottom line is, that even with substantially lower oil prices, Pan-Ocean has outstanding upside. But if oil prices continue to ascend, as we expect, we look forward to a significant stress reduction program. Maybe we can finally give up the martinis.

Pressing the Bet, Part II

EastCoast Energy, spun out of Pan-Ocean last year, is a Tanzanian producer of natural gas with enormous reserves. With limited capital expenditures moving forward, the company should throw off large amounts of free cash flow—supplying gas to energy starved Tanzania for electricity generation.

Canadian Superior produces over 3,000 bbls per day from Western Canada. If we add the mere land value of its other Canadian assets, including offshore Nova Scotia where the company is one of the area's largest landholders, we are getting for free the company's substantial Trinidad potential of several trillion cubic feet of gas. Whenever the company secures its farm in partner(s) to drill its Nova Scotia and Trinidad prospects, this stock should move higher.

Delta Petroleum is a natural gas producer operating in the US with its main focus on deep gas in the Rocky Mountain region. The company trades at a 25% discount to our current net asset value and could dramatically increase that value over time given its drilling prospects.

Rally Energy, another of our favourites, produces oil in Egypt, where it should double its production to 6,000 b/d by year end, produces about 600 b/d in Western Canada and holds a 22.5% working interest in gas fields in Pakistan that could have reserves of 2 to 3 trillion cubic feet. We think this stock, which trades at half its current net asset value, could double in a year, but could ultimately go much higher as reserves and production increase.

Sterling Resources (UK North Sea and Romania), *Corridor Resources* (New Brunswick and Nova Scotia), *Canoro* (India), *Connacher* (Alberta), *Vulcan* (Newfoundland) and *Kodiak* (Wyoming) all trade at a discount to net asset value. These companies are trading at levels below that of their aggregate land values, cash on their balances sheets and oil and gas reserves (using substantially lower than prevailing commodity prices). We believe each of these companies has outstanding upside beyond their NAVs based on the earnings and cash flow potential outlook at each company.

Yellow Gold

We continue to believe that gold and silver prices are heading higher. Demand has outstripped supply for many years. However, central bank selling, producer hedging and the carry-trade provided enough supply to cap prices. Over the past two years, the producers have reduced hedging materially, the carry-trade has ground to a halt and central banks have either run out of gold to sell or now prefer the metal to US dollars. In 2004, less gold was produced in the world than in 2003. South Africa, once the world's largest gold producer, produced the least amount of gold in 2004 since 1931. Moreover, as most companies were previously high grading and with higher production costs for labour, fuel, power, steel, cement and local currencies, Q1 '05 results have been dismal. Clearly a higher gold price is needed or the industry will continue to shrink. Get ready for higher prices.

The North American institutional strategist for RBC Capital Markets recently pointed out that whenever the ratio of the price of gold to the Philadelphia Gold & Silver Index (the XAU) exceeds 5 (only 12% of the time in the past 22 years), the average annual return from the XAU has been 38.4%. Gold is now 5.2x the XAU, meaning gold stocks are cheap, and if you think bullion is set to rise—hmm.

Our vintage dance instructors also recall that, in 1980, gold was over $800 per ounce and traded at a ratio of 1x the Dow, which was around 800. Now the Dow is 25x the price of gold. The ballroom boys recall in the early '90s when gold was 25x the price of a barrel of oil compared to today's 8.5x. Heaven help us if you compare it to the average house price.

It used to be said that gold should trade at the price of a man's fine suit. These days gold trades at about the price of a pair of fine trousers. When it gets to the price of a necktie, we're really loading up.

Like our oil stocks, our gold stocks don't necessarily need higher gold prices to prosper. *High River Gold*, *Etruscan* and *Yamana* are all set to triple their production in the next couple of years while production costs for each remain well below the price of gold. They trade at substantial discounts to net asset value whereas substantial premiums to net asset value are afforded to most companies producing at the levels these three will be at shortly. Based on conservative earnings multiples, these companies should trade much higher over the next two years. The same arguments could be made for *St Andrew Goldfields* whose Timmins, Ontario operations and Nixon Fork, Alaska operations should be producing in the near term. St Andrew continues to trade well below net asset value and at a very low price relative to its near term prospects.

Iamgold trades closer to fair value, but is adding value with a potential important discovery in Ecuador and should trade higher particularly with an increase in gold. *Pan American Silver* is a pure silver company and one of the largest global producers. Silver is in an even greater supply-demand deficit than gold. Almost none of the silver producers make any money so, again, get ready for higher silver prices. Though Pan American is never really cheap, we use it as a proxy for the commodity itself.

Strategies For Today

We are sometimes asked whether we are too "aggressive" because we're overweighted in oils and in golds and have an abundance of smaller cap names. We have said and written constantly that we go where the opportunities from time to time are the most attractive. As groups, we think the oils and golds are exceedingly attractive. Because the golds are currently so unpopular and because it's so uneconomic for them to make money at current bullion prices, the golds may be the most dynamic of all, especially when bullion gets going, as it will.

All things being equal, bigger is better. But all things are not equal. Some of the bellwethers, IBM, Kodak, Fannie Mae, AIG and many others, have been trounced. Global competition seems to be affecting the big guys more. Imagine, GM and Ford are junk. And the big accounting scandals have mostly been directed at the big guys.

The little guys today are cheaper because they're more innovative, more entrepreneurial, more nimble and, like us, opportunistic. Obviously, a new discovery in a junior company will have more impact than in a senior. A bigger bang for the buck. Moreover, they are more analyzable, with fewer moving parts and we can get to know their managements personally. But because they are generally underfollowed, in an illiquid market they become relatively much cheaper than their big cap brethren.

So, as value investors, we are driven by their exceeding cheapness into the small and mid cap names, for this period anyway. These today represent better upside with less risk.

If buying small and mid cap names that are cheaper, have pristine balance sheets, are understandable, with above average growth characteristics and familiar managements, makes us appear to be aggressive, then so be it. We think it's prudent. We're into real performance, not appearances.

Our less liquid names may make us more volatile. While volatility, or "standard deviation", in some textbooks equates to risk, for us, as consummate value investors, patience and suffering more short-term volatility in the conviction of an inevitably higher outcome means prudent, lower risk, higher reward investing.

Needless to say, whenever a larger cap name, such as *Pfizer* or *Nextel*, which we currently own, has value characteristics competitive with the smaller caps, we'll prefer the larger ones every time. Indeed, with the year-to-date sell off in stocks, we are seeing much more value. Names like *Commerce Bancorp*, *TJX Companies*, *Wal-Mart*, *Friedman Billings Ramsey*. But, for the moment, the prospects and undervaluation for our oil and gold holdings are so compelling, we continue to remain concentrated in those areas.

This period will pass. Sooner, we hope, than later. While we're not stressed from the markets, per se, whenever our clients are fretful, we suffer vicariously. But we're confident in our analysis, we love our companies and it's comforting to know that the mere passage of time should give us the returns we seek. And, maybe, then some. The clients will be relaxed again and our team will be dancing in the streets. Ain't stress grand.

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May 19, 2005