

ANATOMY OF A BEAR

As you know, we believe we are in a bear market which began in earnest, even for the hottest stocks, well over a year ago—in fact most stocks peaked in April 1998. We also believe that the first phase of the bear ended around the end of May 2000, and that we are now enjoying a brief relief rally, some would say a “summer rally”, although inveterate bulls like to think the decline is over, that most of the interest rate hikes are over and that it’s up and away again to new heights. Our favourite investment strategist, Don Hays, calls the latter group “Denialists”.

Bear markets can be broken down into three phases. The first, which we’ve just gone through, is the “Denial” phase, when investors, fed by the media and analysts and their own recent recollections of how successful it has invariably been to “buy dips”, believe it’s nothing more than a mere temporary correction. The second, the “Concern” phase, is characterized by investors becoming worried that stocks just aren’t acting as they should, by earnings disappointments, maybe by interest rates and inflation going higher than anticipated, maybe by an economic slowdown becoming apparent and by more negative than positive surprises occurring. Investors in this phase start to think that maybe buying dips isn’t always successful. In the final “Fear” phase, the press is full of gloom and doom, investors are full of fear, can’t take any more pain and dump stocks at any price, vowing to never buy dips or stocks again. The cleansing is then complete as we’ll have gone from the incredible greed at the top of the market to the fear at the bottom. Naturally the best time to buy is during the Fear phase, the mother of all dips, as the prices are the lowest, investors are capitulating, the economy has slowed and the circumstances in place for the birth of a new bull market.

We think we’re close to the beginning of the second phase. The market is becoming “overbought” again. Investor sentiment has greatly improved—the put/call ratio the lowest in a year—and valuations have risen again with the NASDAQ up 40% in just a matter of weeks, the S&P near its highs and the TSE, thanks to Nortel, making new highs. All the while liquidity is deteriorating as the Federal Reserve Board continues to reduce the growth of money supply, a factor which invariably leads to declining markets and a slowing economy. And other ominous signs. Oil and gas prices look like they’ll stay high. The labour market continues incredibly tight. Shortages are developing. Commodity prices are rising. Inflation is picking up and so the Fed may not be through raising interest rates. Maybe once more in August and again after the US election in November. Of very great concern to us is the US trade deficit and its impact on what could be a topping US dollar. A declining equity market and a declining dollar will feed on each other as foreigners repatriate their dollar investments.

As we watch the market daily, it is apparent to us that even though the averages are rallying, the market has clearly lost its old spunk. Many of the leaders are well off their highs; Microsoft, Oracle, IBM, GE—some, like Cisco, even discredited as their valuations and growth strategy are called into question. Some, like Amazon.com, even regarded as potential failures as their business models and cash adequacy are called into question. Most internet stocks are well off their highs and many are failing. Many more will. The new issues market is less active and the majority of recent new issues have not appreciated. Failure to make earnings expectations, even by a mere penny per share, can typically cause a significant decline. And valuations in Techland remain nuts.

With the market indexes now consisting of a high proportion of overvalued tech stocks, the Dow (30% technology), the S&P 500 (45% technology), the TSE (Nortel alone, 35%), and the NASDAQ casino, with 97% technology, those indexes could all be dragged down in volatile fashion when the lofty valuations of their tech members are brought back to earth. And because technology and telecom span the world (for example, 26% of Japan's index), when the tech and telecom bubbles burst, all the world's markets will come down together.

So what to do if we believe in our bearish scenario? Our primary objectives are to preserve capital, to have some reserves to buy the bargains we envisage, to hold only cheap stocks with high reward to risk ratios and, where clients permit, to hedge portfolios by short-selling overvalued stocks. We are tending to buy a potpourri of fixed income ideas, such as Gulf Preferreds, Residential Equities REIT, Sunglass Hut Convertibles (see Randall's recent article enclosed), Hurricane Hydrocarbon bonds, and Agnico Eagle debentures. We are also tending to buy more liquid, large cap companies so we can make a quick getaway if we have to, and we are building an overweighting in gold stocks which historically have correlated negatively with equities, that is, they go up as the dollar and stocks go down. A natural hedge.

We could take a really bearish posture and raise lots more cash but we don't for the following reasons. No two bear markets are the same. Some occur during deflations (1930s), some during inflations (1970s), with different implications for different groups of stocks. Different bear markets have different durations and degrees of severity. So we have to be aware of the differences and roll with the punches. And then too we could be plain wrong. Each market has its own peculiarities and this market is characterized by the extreme disparity in valuations ranging from some hugely overvalued groups of stocks and most averages to some very cheap groups like oils, golds, retailers, and basic industries. So, while the NASDAQ 100 trades at an excessive 144x earnings, the Value-Line Index (1700 US stocks equal weighted) has a price/earnings ratio of only 13x. From the cheap groups we have been picking up some quality companies, especially after they have declined on bad news (usually of a temporary nature), with a view to trading some of them out on the anticipated bounce. This kind of trading is unusual for us because we tend to be longer term value investors, but when the main trend is expected to be down, we need to be opportunistic. Thus we recently made a quick 20% on Bristol Myers after it collapsed to around \$48. We have recently bought H&R Block, Abercrombie and Fitch, TJX Companies, Honeywell, and now, Jones Apparel

Group, all near their lows, all very cheap, high quality companies that are profitable, growing their sales and earnings, and have strong balance sheets. Most of these companies are buying their shares back because they are trading at very low valuations relative to the market, to their own historical valuations and most of all, to their intrinsic values. We watch them carefully and, while we hope to profit from them, we can exit quickly if we're wrong.

We also hold stocks that can go up regardless of the market's direction, like Goldfarb which we expect to return 100% profit over the next 18 months as it liquidates its businesses and returns the proceeds to its shareholders. And like Hollinger, where Conrad Black, frustrated by the market's unwillingness to recognize the inherent value of the stock is looking at liquidating newspapers to fund a buyback of his undervalued stock.

We're also holding very cheap oils because we believe high oil prices may exist for some considerable time though the market seems to believe otherwise. We own Canadian Natural Resources, one of Canada's largest independent oil and gas producers (it just bought Ranger Oil which should add to its growth). It also has a large proportion of natural gas production for which we believe the outlook is particularly positive. We hold Hurricane Hydrocarbons which has already been profitable for us and with its fast growing cash flow and earnings could double again in the next year. And Pan African Energy (formerly Ocelot) which still remains unpopular, but is still incredibly cheap, trading at not much more than its cash on hand per share, with such great potential for significant volume, earnings and cash flow growth over the next couple years that investors will be forced to take note and price the shares much higher.

Finally, we hold gold stocks including, blue chip, Franco Nevada (now merging with Consolidated Goldfields to become one of the largest gold producers in the world) and Dundee Precious Metals Fund (trading at a 36% discount to its net asset value and set to become a producer as it acquires Hope Bay Gold); River Gold, a small Ontario (Wawa) producer with good grades, good management and good prospects.

We're not gold bugs, but as value investors we are clearly contrarian and tend to gravitate to the bargains that are out of favour. Gold is clearly out of favour. After all, it has mostly gone down for 20 years. But its prospects for rising are improving. For a number of reasons, but mainly central bank selling and leasing of their gold reserves and excessive producer hedging, gold has been kept lower than it should be. It's clearly out of whack. Relative to its traditional relationship to platinum and palladium which have skyrocketed, to oil which has skyrocketed, to the CRB Commodities Index which is up 20% and rising, and to real asset inflation generally (real estate, art, etc.), gold should be rising. Annual production of gold is flat and jewellery demand alone consumes it all. The low prices discourage exploration for new reserves. There is some evidence that the professional "short" position in gold is more than a third of all the gold held by central banks and that a short squeeze could develop which could seriously hurt some large dealers and bullion banks. So they have an incentive to keep the price low and likely have been. But, of course, they won't be able to do so indefinitely. The total capitalization of all the public gold companies in the world is probably

half of Bill Gates' net worth. So it wouldn't take much shift of capital to affect prices sharply. And it appears some "smart money" like Bill Gates, Warren Buffett, George Soros, Larry Tisch and Li Ka-shing have been acquiring gold and silver interests.

Our work shows that the gold stocks are at historic lows and are buys. As important, we believe they are hedges against a falling stock market.

Our clients generally are in synch with our outlook because it's a common sense one. Momentum in technology stocks is waning and any momentum investors that are left when the decline starts in earnest may have to look elsewhere, like maybe oil and gold stocks for their fix. Now is not the time to be greedy. It is time to be careful. So we're not chasing large potential returns with large potential risk. We want to position the portfolios to weather the storm, and even to capitalize on it by picking up the bargains when those investors who were conditioned to buying the dips turn to selling them.

Randall Abramson, CFA

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Enclosure