

## THE GLASS IS HALF FULL

Other than for brief occasions, including the aftermath of September 11, we have been mostly bearish for the last 3 years. Our last quarterly letter was particularly so. But after this last ugly decline, we've now turned bullish and have become fully invested. Being bearish during 1999 and 2000, while the market was peaking at "irrationally exuberant" levels, was trying, inasmuch as we weren't participating as we would have liked on the long side, and being short, prematurely, was harrowing indeed. For example, we first shorted Nortel at US\$75 and rode it up to US\$115. Painful. We stayed with it and shorted it since a couple of times, successfully. It's now a penny stock. Vindication. The point is, no bell goes off to signal tops and as value investors and contrarians, we took some pain at the topping inflection point. Similarly, no bell goes off at the bottom and though we think we're now at a bottoming inflection point, we've had to endure some inevitable pain until the turn we think is close finally materializes. Though there is a specific high and low point, these are impossible for mere mortals to catch perfectly and with the desired portfolio composition. So for us, topping and bottoming are processes. We anticipate them based on macro factors and psychological indicators, and we actually invest or disinvest based on "bottoms up" valuation techniques—i.e., individual stock picking.

We've turned bullish now because we think the markets as a whole are at compelling valuations, that the psychological indicators are at the extreme levels normally associated with bottoms, but mostly, because most individual stocks have bottomed and are at extraordinarily attractive prices. And this business, for us, is about buy low, sell high. Diversify. If it's a mistake, sell it. Period.

### Historic Valuations

No matter what you hear, based on our work, at their current valuations and at prevailing interest rates, the equity markets represent extremely good value, just as they did at the March 22, 2001 and the September 21, 2001 lows. These bottoms all occurred at the same important price to book value support level as today's prices—in the case of the Dow, at over a 40% discount from Fair Market Value, a larger discount than occurred at 9/11, the crash of '87, at the end of '95, at the bottom of the Asian flu of '98 and on March 22 of last year. In fact, the recent low on the Dow on July 23 was the greatest discount from Fair Market Value in our work since WWII. Extremes seem to beget extremes. After the highest historical overvaluation relative to Fair Market Value just two years ago, we're now seeing the opposite.

While some pundits think that P/E multiples need to go to 10x earnings, or lower, as in '74 (compared to the long-term mean of 14x), today's interest rates of 4% easily justify the current multiple of 15x forward earnings. Admittedly, the two variables, both interest rates and earnings, need to be examined. Earnings, are coming off depressed levels, and though economic recovery is suspect because the consumer is financially stretched and his sentiment is depressed by the falling stock market and rising unemployment, per share earnings should be supported by cost cutting, restructurings, consolidations and share buybacks. US profits in Q2 rose after 5 straight quarterly declines, with 60% of S&P companies beating estimates (though many companies are lowering forecasts for this quarter). Nonetheless, the latest IBES estimate for S&P operating earnings for the next 12 months is \$56.47, up from \$45.00 at the end of 2001. As for interest rates, it is hard to see the Fed raising interest rates with the stock market so depressed, with a sluggish economic recovery, with deflationary forces at work, with weakening consumer sentiment, with an overheated housing market that needs continued low mortgage rates to sustain it, and with record corporate and personal bankruptcies. On the other hand, recent high monetary liquidity, a declining US dollar (down 10% on the index from its high this year), rising house prices (up 16% nationwide in the US in the last 6 months) and rising commodity and real asset prices suggest upward inflationary pressures, not a prescription for continued low interest rates. In the meantime, however, they are what they are.

Not only is the Dow at an important support level and greatly undervalued, so is the NASDAQ, the S&P 500, the Russell 2000, other foreign markets and our own TSX. Many of these are at 5- and 6-year lows. Imagine 6 years of gains wiped out. And now you're worried?

But most important, many individual stocks are now exceedingly cheap, some as cheap as they've ever been. Big cap safe-dependables, like Merck, Johnson and Johnson, PepsiCo and Kimberly-Clark are at multi-year valuation lows. 25 of the 30 Dow stocks have hit support levels on our work, usually indicating a bottom for the Index as a whole. Panicky investors and mutual funds incurring redemptions have been selling not what they want to, but what they can. Fearfully and indiscriminately. Accounting scandals and bankruptcies abound to be sure, but are being magnified by exploitive journalists and politicians, unduly influencing already nervous investors to dump stocks.

In the smaller cap arena, stocks such as our core stocks, CryptoLogic and Hurricane Hydrocarbons, partly from the general market malaise but also from their own peculiar short-term problems, have hit valuation support levels that make them incredible bargains. CryptoLogic, with over \$3.00 per share in cash and no debt, should earn \$1.00 with earnings power closer to \$2.00, giving it a multiple for its share price ex cash of 6x this year's earnings and only 1.5x its potential earnings. Look for another large share buyback. Hurricane, with virtually no net debt and growing its production in 2003 to 165,000 barrels per day, at \$10.00 is trading at less than 3x next year's earnings, and at only 1/2 of its net asset value. Look for a potential takeover.

During earlier periods, when we believed the markets were grossly overvalued, we could find little to buy and lots to short sell. Today, it's quite the reverse. We're seeing so many stocks we want to buy we feel like kids in a candy shop. Warren Buffett says, at bottoms it feels like you're the only guy in a harem. We acknowledge having a sweet tooth, but we actually relate more to the harem analogy. Conversely, for our hedged accounts, we're finding little we would want to short.

## **Portfolio Strategy**

We see enormous potential in our current portfolios. Chockablock full of cheap quality companies. To the point where, uncharacteristically, we've even taken on a little margin to increase the number of stocks we can own. While the market's decline has been accelerating, as is usually the case in the capitulation phase, and while we've taken much more pain in June and July than we would have liked, stocks are at such bargain valuations that the risk of further significant loss is far outweighed by the opportunity for significant gain over the next few months. The market may already have bottomed this week. If not, there is the possibility of a further 15% decline to a lower support level of, say, Dow 6900, over the next few weeks. We may have to react somewhat to mitigate the loss in the short run, but that would certainly be the buying point of a lifetime.

We have been more bearish than most money managers, our last quarterly letter comparing today's environment to the 1930s. Now everyone's talking about it. But if we're not at the low, we're almost there. Most of the decline in equities is over. The NASDAQ, down 80% from its peak in 2000, has lost almost as much as the Dow did from 1929 to its bottom in 1932, everyone's current favorite comparison. But make no mistake, there are great differences today. Way less leverage in the market (investors could margin up to 90% then); a reasonable economy (3.5% GDP growth this year) compared to an economic depression then; over 20% unemployment then, without unemployment insurance or other modern safety nets; a much higher standard of living today and, of course, greater national and individual wealth; a higher level of economic sophistication and tools to deal with declines; a banking crisis then when thousands of banks closed their doors, and so on. Moreover, then there was a great deflation (exacerbated by a misguided restrictive monetary policy) which we sure don't see now, whether in housing, autos, appliances, commodities, services or wages. In fact, we think, as a result of the dollar's decline, increasing fiscal stimulus, the huge increase in money supply, rising commodity prices and, the diminution of competition as weak industry players fail, that the surprise on the horizon could be more inflation not less. And, as investors, if we have to choose between the deflation of the '30s and inflation, we'll take inflation every time. Each bear is different and needs to be examined in light of its own peculiar circumstances. Nobel Laureate economist, Dr. Milton Friedman, contends, "We learn from history that we do not learn from history."

## **Why Equities?**

Since the peak, equity losses by investors of \$8 trillion, may indeed cause the economy to suffer a double-dip recession as consumers retrench. The consumer sentiment figures for mid-July were at an eight-month low, and accordingly, corporate earnings in some groups may suffer. Retail stocks sure act poorly. Then again, what doesn't. But history has shown that there are periods when there is, indeed, a disconnect between equity returns and the economy. A recent analysis by Refco Global Research looking at different 5-year periods suggests that a strong economy has little to do with rising stock prices. For example, between '95 and '99, equity returns were extremely large, but economic growth differed little from nine other 5-year periods. Conversely, between '40 and '44, economic growth was extremely strong (World War II), but equity returns were held down.

The overriding factor is equity valuations. And, according to our work, stocks are very cheap, no matter what you hear from the doomsayers. No matter if the economy has a minor downdraft. In fact, we think that's likely. Bill Clinton once said, "It's about the economy, stupid!" meaning that's what counted for reelection. But as for what counts for investors to make money, "It's about the valuations, stupid!"

Those who believe this market is still high at 15x earnings expecting a P/E multiple, of 7x, as in the ugly bear of '74 simplistically ignore the fact that interest rates then were substantially higher and rising due to double-digit inflation, and then, interest rates proceeded to double over the ensuing 5 years. Not to mention Nixon's impeachment. Whereas, in fact, market corrections in 38 of the last 75 years didn't take the market below a 15x multiple.

Equities can be looked at as perpetual bonds. Just like bonds have a yield, say, of 4% in the case of the 7-year US treasuries we deploy in our work, equities which trade at 15x earnings have a reciprocal earnings yield of  $100\% \div 15$  or 6.7%, which is a significant 67% higher return than the 4% fixed income return. Moreover, in Canada, the after tax return from a dollar of capital gains is 50% greater than from a dollar of fixed income. And, unlike bonds, stocks also provide a hedge against future inflation. Importantly, unlike a bond whose income is "fixed", corporate earnings grow, and when they're depressed, like now, they really have room to grow. Earnings grow because economies, inexorably, grow over time. The most important aspect of equity investing is that equities have an innate upward bias. Over time, they always grow, despite their periodic fluctuations. That's why equities over extended periods outperform bonds. And every other asset class too. Bonds have now outperformed equities over the last 8-year period. Well, call us contrarian, we want to buy what's been underperforming, because, odds on, it will regress to its normal mean. That means, odds on, stocks should outperform bonds and probably all other asset classes over the next several years. One dollar invested at the end of 1925 in US large cap stocks would have been worth \$231.22 at the end of 2001 for an annualized inflation adjusted return of 7.43% compared to 2.18% for long-term government bonds and 0.73% for T-Bills. It would appear that, for equities, the glass is usually half full.

Sometimes too, unlike a bond, regardless of current earnings, we can buy a stock for a lot less than its net asset value, as in the case of Goldfarb, Speedy, Pan-Ocean, Northgate or Hurricane, and depend on the mere passage of time to give us a better than bond return as the shares rise to their net asset value. Often, companies pay out their earnings as dividends, sometimes as a large extraordinary dividend as Hurricane did when it paid \$4 per share. And as Goldfarb and Speedy did and will again. Or better still, from a tax standpoint, companies may buy back their shares, at a premium to their trading prices, as did Pan-Ocean and CryptoLogic.

### **It's All In The Market**

We anticipated this bear market. And our almost four-year returns to date reflect it, though we wish we'd been more defensive through July. We've been too early. But we were also too early when we started shorting in the bubble mania. Recall the Nortel example. Early often means being short-term wrong, but a long-term hero.

In our last letter we talked about the worrisome problem of the excessive debt of governments, corporations and consumers. The high level of bankruptcies. The accounting scandals. The housing bubble. The declining dollar. The US trade deficit. The war on terrorism. In short, what everyone is talking about now. But the difference, and it makes all the difference, is that since then most markets have dropped by 20-25% and many stocks by much more. We think all that worrisome stuff, and we concede there's lots to worry about, is "in the market"—that it's fully discounted, and then some. Furthermore, now that the problems are exposed doesn't mean that they're worse. To the contrary, that's when they get addressed.

We think since 9/11 the world has become a safer place. Osama and Yasser are on the run. Saddam is next to go. He might even resign, unless he has a death wish. Terrorism is being confronted everywhere. The US is looking to get less dependent on oil from its Middle Eastern "friends". The Cold War is over; there's only one Superpower left and he's our friend. Similarly, the investment world is becoming a more honest place. Congress, the SEC and FBI are hard at work catching dishonest companies. JP Morgan and Citibank are being investigated for their parts in the Enron scandal. AOL Time Warner is being investigated by the SEC for accounting irregularities. Accounting standards are being cleaned up. Auditing and consulting functions are to be separated. Some companies are even starting to expense stock options, a contentious issue. Coke's doing it. Now even their earnings will be "the Real Thing". Exposed executives are being indicted; many will go to jail. As of August 14, CEOs of large companies will be required to certify company statements on penalty of incarceration. We're looking to invest in a good prison REIT. It should become a growth industry. But isn't all of this progress, if investors will be able to rely on financial statements, and on analyst reports, which may need to be certified soon too?

More important than all of that, from a stock investor's point of view, is that corporate America is restructuring, cutting costs and lowering breakevens. Even much maligned Kodak, for example, is now more profitable on 7% lower sales. Whenever final demand improves and sales pick up, corporate earnings will too, big time.

The news, when discounted, as now, doesn't have to be good, just not as bad as everyone expects. And everyone today expects Armageddon. The news is so bleak it must all be "in the market". Any contrary surprise would more likely be a positive than a negative. Don't look for the news necessarily to get better, just for the market to get better. Guess what, after all but one of the last 9 bear markets, the market was up 30% one year later. Short-term pain for short-term gain.

Everyone seems to be discounting the remarkable technological revolution we're in the midst of. Knowledge is growing at an awesome pace. In telecommunications, information technology and biotechnology. Those who pooh-poo the productivity improvements of the past few years must be blind. We see those improvements in our own office. Maybe there has been too much capacity created too fast. It's correcting itself. Too much unlit optical fibre. Well, there wasn't any optical fibre a few short years ago. So maybe Global Crossing won't own it, but it's still there and another "beneficiary" will operate it, after getting it on the cheap. But business and consumers will benefit.

We're going through a correction, a cleansing process. Too much capacity. Too much debt. The capacity is shrinking and some will be scooped by others from its current insolvent owners. Debt will be repudiated. Overextended borrowers will go bankrupt and their lenders will suffer writedowns. But the economy will survive and be better for it. If a credit crunch comes, the Fed, predictably, will prefer borrowers to lenders and make available all the liquidity necessary to keep the system running, even if the result is more inflation. Deleveraging, restructuring, and focussing on core competencies are in; leverage and recklessness are out. Transparency is in; deception is out. Corporate reform is in; "infectious greed" is out. GAAP earnings are in; pro forma earnings are out. Low price to earnings ratios are in; high price to sales ratios are out. Value is in; momentum is out. Rationality is in; bubble mania is out.

And by no means are we at the beginning of the process; we're well through it, and the market has discounted it in spades.

The glass is half full, not half empty. We believe that, even if stocks go a little lower first, ultimately, our glass will runneth over.

## **Bottoms Up**

In our shop, we believe it's now time to focus on being "bottom up" investors. Value investors picking really cheap stocks. Ignoring the headlines. Merely shrill, transitory noise. Sometimes investors can't see the forest for the trees. We now think they can't see the trees for the forest. And the trees are wondrous to behold. Mature oaks for the price of saplings. In the past, as value investors, at market dips, when certain groups fell out of favour, or certain companies had a hiccup, we were able to buy "good companies at good prices". Today, for the first time in many years, we are able to buy "great companies at great prices". Sure, we love our absurdly cheap CryptoLogic, Hurricane, Pan-Ocean and NewAlta—but now we're talking Johnson and Johnson, Kimberly-Clark, Shaw Communications, Liberty Media, AGF, McDonalds, Scientific Atlanta, CAE, Bristol Myers, Home Depot and Cendant. Important world-class companies, with important business franchises. Companies that will have reliable earnings, cash earnings at that, even growing earnings, even likely in an economic downturn.

You just can't buy anything. We need to be discriminating. We don't want telecommunications, yet. Too much capacity to come out. Unreliable earnings. Or airlines for the same reason. Or semiconductors or computer stocks, yet. Weak demand and they still look inferior on our work. We'll avoid housing stocks because we think housing is overdone. Home sales are slowing. We're going to wait on banks because loan losses are still rising. We need to pick the right stocks in the right groups. Like makers of Band-Aids, drugs, Huggies. Like cable TV operators or purveyors of its content. Defense stocks while a war's going on. Oil stocks when the world's running out of the stuff. Gas stocks in a heat wave. Food and beverage stocks because they're always safe and dependable. Mutual fund managers when the market's about to reverse. Insurance companies because premiums are rising. Gaming stocks because it's a growth industry.

Utilities. But only the strong ones. Commodity cyclicals, because prices are set to rise. Golds because of more inflation, because the dollar will continue weak, but most of all, believe it or not, because there's a shortage of the metal. We want companies that benefit from the decline of the US dollar. Multinationals. Companies that will give us a reliable earnings yield, better than bonds and way better than cash. Companies that have excellent balance sheets and superior management. Companies that will opportunistically buy their own shares back when they're so cheap from panicky sellers and will even use their strength to devour weaker competitors or to diversify.

Look for more consolidations, like Pfizer acquiring Pharmacia, to save that merged entity \$2.5 billion in annual costs. And low ball acquisitions. Like Warren Buffett, the master scalper himself, investing in Level 3 Communications so it can in turn steal the bankrupt fibre-optic network operator, Williams Communications. Like Brascan stealing 63% of AT&T Canada with a view to restructuring it. Like KKR, US leveraged buyout experts (read, "scalpers" too) buying some "non-core" businesses from Siemens for \$1.69 billion. When Buffett and Brascan and Kravis are buying, we should be too. Look for TransCanada Pipelines and other strong utilities to buy some assets, no, steal some assets from the bankrupt US utilities. Look for Cisco, with all its cash, to pick up some pieces if Nortel or Lucent go down. Look for Dell to continue to gain market share. Creative destruction at its finest.

We want to buy survivors and beneficiaries. We want to buy companies that have current earnings, preferably cash earnings, that we believe can grow even if they're in a current temporary lull. We only buy companies that have strong balance sheets, that don't depend on external financing to survive and that can benefit from their current depressed share prices and those of others as well. These have to trade at depressed multiples of earnings, relative to interest rates, their normal multiples, and their growth rates and at a significant discount from our definition of Fair Market Value. And we diversify, lest we make a mistake. These days there are so many beauties in the harem, diversification makes us almost feel promiscuous.

We're so excited about the bargains to be had not only have we gotten fully invested, and then some, we've even reduced our treasured gold weightings (we'll come back to them in due course, gold being in an early stage bull market) and some income trusts, to raise the cash to buy the bargains. As for gold, we actually think the recent pullback in gold is logical. It is rationally forecasting a stock market rally, and a US dollar rally also, both from their depressed levels. So we think, also, is the long-term bond market, which with all its apparent attractiveness refuses to make new highs.

## **The End Is Nigh**

As for the market itself, whether the ultimate low is 3 hours or 3 weeks away and whether it's somewhat lower than now, it's certainly close at hand for, at the very least, a significant bounce. All the psychological indicators we look at indicate a bounce is nigh. To all the world it seems the glass is half empty. Everyone is bearish. The news is bleak. Perfect. The Arms Index (comparing volume of advancing to declining stocks), the VIX Index (volatility), the McClellan

Oscillator, the put/call ratio, the ratio of investor services that are bullish to bearish, the record high short interest, the high level of odd lot shorting, the low percentage of stocks above their 200-day moving averages, the number of new lows vs. new highs, the very high trading volumes (allowing frightened holders to exit), the high volume of mutual fund redemptions (\$4 billion per day, more than twice the rate after 9/11), the Bear on the cover of Business Week, the frantic calls we're getting from clients, all suggest to us that we're mighty close. We've culled some key buzzwords from the recent news coverage: "meltdown", "tsunami", "panic", "crash", "systemic failure". Need we say more. No wonder people are giving up on the stock market. The same Mr. Buffett, of harem fame, once explained his strategy like this, "We simply attempt to be fearful when others are greedy, and to be greedy only when others are fearful." Clearly those others are fearful now, so Mr. Buffett has to be feeling greedy. He's worth \$35 billion by investing at times like this. We want to do as he does.

Bear markets end not because there's a sudden sea change in sentiment. It's because the selling finally exhausts itself, the bad news is fully discounted, and the value asserts itself, regardless of any temporary negative outlook. The laws of supply and demand apply here too. Recently, corporate buybacks and insider purchases are greater than new issues of stock.

Best of all, there are apparently 6,000 hedge funds in America whose business it is to short stocks and who will need to cover their shorts when the rally starts. And, even better, there's no shortage of cash to fund the rally. There's almost \$6 trillion of cash on the sidelines, \$2.3 trillion of it parked in money market funds, earning a pittance. You know it's coming back in at much higher levels when the water appears safe for swimming again.

Bottom line is, the water is safer. The world's becoming a safer place to live and a safer place to invest. So, for us, the glass is half full. But one thing we promise, we'll continue to be cautious so that if we're wrong, at least we'll still have a glass.

Herbert Abramson and  
Randall Abramson, CFA

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