FOREST FOR THE TREES

Legendary US investor Bernard Baruch, when asked in a depression-era Congressional hearing for his views on the stock market, replied, “It will fluctuate.” And fluctuate it has recently, indeed. Mostly downwards. Picking up steam on the downside lately from a surprisingly poor US jobs report for July, merely 32,000 new jobs, about 1/7 of what was expected. On Friday past, the Dow sank to 9815, its lowest close in more than eight months, down over 8% from a 2 year high in February. The NASDAQ composite index has been worse, plummeting 17% since the end of January. In Canada, the July jobs report modestly disappointed too and the S&P/TSX composite index has fallen 8% since its April high.

The Post Mortem

Unfortunately, our portfolios haven’t escaped the carnage. The June quarter was down and July was a poor month (less so for our nontaxable accounts which have less US market exposure), but not so much from the impact of the overall market as from our trading mistakes and miscalculations. Nostra culpa, or whatever the plural of “mea” is. 60% of our decline came from two technology stocks recently bought, as disclosed in our last quarterly letter. *Conexant* lost half its price and *UTStarcom* a third. Paradoxically, our golds, which normally are negatively correlated with the market, made up the balance of the decline, as gold stocks were dumped too from the peril that holders of equities and bonds perceived, namely that interest rates were on their way up and threatened all financial assets.

Thank goodness for our overweighting in the oils which rose with the price of crude. In fact, our two biggest holdings, *Pan-Ocean* with excellent drill results and *PetroKazakhstan*, with a huge share buy back and record earnings, both recently made new highs.

Despite a down June quarter and the general market malaise, we stand by our belief, enunciated in our last quarterly letter, that the market bottom is nigh. We also now know, of course, that we were a little early. But in the investing business, even though it comes with some short-term pain, a little early is better than too late. A trade-off between exposure to limited downside against missing a bigger upside opportunity. As gold watcher, Bill Murphy says, “You gotta be in it, to win it.”

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Black Boxes and Fast Funds

Declining markets are always painful for holders of equities. But we perceive that the current volatility in stocks is greatly augmented by the proliferation of certain kinds of hedge funds that use computer driven momentum models, "black boxes", to jump on weakening stocks and short sell them vigorously till they are dumped by weak holders. And, conversely, to push up overvalued and heavily shorted issues, to squeeze the shorts. Some of these are "fast funds", which drive the direction of the security for a very short time, often intra day.

A sophisticated New York client of ours says, "You always need to know who you're keeping company with." If Pan-Ocean had missed its estimate by a penny it would not be material. No black boxes or fast funds here. But for volatile NASDAQ technology stocks, Conexant and UTStarcom, despite being already cheap and, when we bought them, already considerably off their highs, missing their numbers is a black box delight. To our regret, we didn't appreciate with whom we were keeping company. We'll try to be more aware of the constituent players in the more volatile stocks.

Auctions Beget Opportunities

As value investors we want to buy low, as low as we can, and sell high, as high as we can. All assets fluctuate in price: houses, art, and collectibles too. But the stock market being a continuous auction with prices and volumes changing, often second by second, sometimes dramatically, presents for us an incredible opportunity to take advantage of merchandise that gets mispriced, for whatever reason, especially when it's for the wrong reason. Volatility created in the auction process may inflict some short-term pain, if you're in before the move is completed, but presents an opportunity to get positioned for the longer term. In the short run, the market is often not efficient. Indeed, it's often irrational. It's governed by emotions, mostly fear and greed, and sometimes apathy. In the long run, reason prevails and the merchandise ultimately gets fairly priced. Of the two emotions, fear and greed, fear is the more powerful, which is why markets usually go down faster than they go up. Humphrey Neill, who wrote on contrary opinion, remarked, "The public is right about the trends, but wrong at both ends."

Forest for the Trees

We think that the current decline, driven by fear, fear of the unknown, of terrorism, high oil prices, rising commodity inflation, war in Iraq, nuclear threats from Iran and North Korea, a housing bubble, rising interest rates, slowing employment growth, slowing retail sales, slowing economy, and, whew, risk of policy changes from a change in the US administration, are all legitimate fears. But average investors, a myopic breed, typically focus on Orange Alerts which are merely the trees, but ignore the forest. It's the trees that preoccupy the Forest Gumps.

The forests, for us, are the enduring market drivers, not the short-term trees, the often irrational fears, mostly driven by headlines. The noise often drowns out the thoughtfulness.

The most important driver for us is that the market is undervalued, in our SVA™ work, by 35%. Interestingly, according to the Fed's model, it is also undervalued by over 32% compared to bonds.

In our work, value is driven by earnings and free-cash-flow, by prospects for revenue, earnings and free-cash-flow growth, by anticipated multiples of those earnings and free-cash-flows and, very importantly, by the forecast for the 7 year US treasury interest rates we employ to capitalize earnings. Indeed, we use these variables in preparing our regular 3 year Rate of Return forecast which ranks our holdings and other companies we're considering.

Earnings and Interest Rates

So, in essence, it's all about earnings, interest rates, leverage, returns on capital and the implied multiples.

Contrary to what the falling market is suggesting, the earnings outlook has not deteriorated. S&P500 forward 12 months' earnings are anticipated to be $70. Therefore, at 1064 on August 6th, the p/e ratio of the S&P500 was 15x, or about the historic median. The "*median*" at a time when interest rates are still near historic lows, the 7 year treasuries yielding a paltry 4.12% (in Canada, 4.31%). Oh, and by the by, fallen angel UTStarcom, with its forecasted 2005 30% revenue and earnings growth, is trading at only 8x earnings, a great value indeed, fast funds be damned.

Recall in our last quarterly letter, we postulated that interest rates would stay benignly low because economic growth was tepid and because the Fed would be reluctant to force rates higher with the economy so leveraged to debt. As we write this, the Fed is getting set to meet on August 10th and will likely raise the Fed funds rate a quarter point because Greenspan has already indicated they probably will. A token rise with no real impact on the yield curve. Watch what Mr. G says at the time. He may recant his bullishness. What Greenspan giveth, he can taketh away.

We can't invest based on someone's outlook for employment and GDP growth. Sure they impact on earnings and interest rates. But they're too unpredictable. Because of a peculiar 91,000 person births/deaths adjustment to the Bureau of Labour Statistics July jobs number, we think it was understated and that the ensuing months will show an improving jobs growth. Another BLS survey, The Household Survey, contradicts it in any event. More important, the reality of the forest is that improved productivity drives margins and bottom lines even if that means fewer hirings or even layoffs, as has been the case for many companies. Daimler Chrysler lays off 6,000 workers and reports earnings up fivefold. Lean and mean is in.

In the end, it's the bottom line that counts for share valuations, not temporary and unpredictable job statistics. And importantly, as even Greenspan acknowledges, corporations are starting to be able to pass on their rising costs. Inflationary? Likely. But profitability is improving. The market has risen during jobless recoveries, 11% in 1991-92 and 25% during 2003 when the US economy lost 600,000 jobs.

Continuing low interest rates probably mean a lower US dollar, a positive in the forest for corporate earnings of multinationals like IBM, Kimberly-Clark and Disney, but also a positive for US competitiveness and ultimate improvement in the US trade and current account deficits. Indeed, the US trade deficit fell somewhat in May.

Commodity inflation should stay high, driven by the growing demand from the developing world and underinvestment in new production. But disinflation in other areas, like telecommunications and computers, and the fact that hourly earnings rises are muted, should mitigate any significant rise in the general price level. But recall, we're betting on a slow growth higher inflation scenario with no meaningful real return from fixed income. Better for stocks than any other asset class.

While high debt levels for consumers and government are distinct negatives, consumers may be starting to save more, and low interest rates mean that debt service is still affordable. And guess what, mortgage rates are not going up so housing will continue to perform. And the US budget deficit, still at high levels of almost $500 billion, is now estimated to be considerably less than originally forecast. An important forest fact is that whoever wins the election, rising budget deficits will have to be addressed—in the case of the Republican by spending cuts, and of the Democrat by raising taxes. The market prefers the former to the latter. Kerry, like Robin Hood, would take more from the rich to give more to the poor. That would be your Sherwood Forest. Perhaps commendable as very Christian to Friar Tuck, but anathema to the prospects for economic growth that could, in due course, permanently raise the standard of living of all the creatures in the forest, big and small.

Good News Too

Moreover, the economic news is mixed. While consumers may be reining in a bit, inventory levels are in record low territory and exports are growing by almost 20%. Moreover, just as consumption spending is subdued as tax refund cheques stop, corporate spending appears set to kick in.

US new home sales slipped 0.8% in June from May's record pace—less than expected—and consumer confidence surged to 106.1 in July from an expected 102, its fourth straight monthly rise. Retail sales in July were weaker (last year's July was helped by child care credits) from higher gasoline prices, but back to school shopping starts about now. US manufacturing strengthened in July from gains in orders and production as The Institute for Supply Management's factory index rose to 62 from 61.1 signalling continued expansion.

And the forest of all forests, the veritable Redwoods, is the potential of the developing world, especially Asia, India and Russia, to continue its fantastic growth trajectory, a benefit to world growth, including North American growth. This is not a cyclical phenomenon—it is secular; it is permanent; it is increasingly profitable. GM is already fighting for market share in China with the Number One, Volkswagen.

Oh, and maybe not the Redwoods forest, but Yellowstone National for sure, is the improvement in Europe as the productivity revolution finally takes hold, as unions lose sway, as the 35-hour work week is attacked, as necessary layoffs are permitted, a sensible immigration policy is allowed to counter scary demographic trends, and market forces are starting to be allowed to work without excessive government restraint.

Terrorism and Oil

As for the war on terror, it may be more in the news, but with each arrest, each skirmish, each shutting down of a funding operation, each improvement in intelligence and now the cooperation of Pakistan, Saudi Arabia, Iraq and other former sponsors of terror, the threat is diminished. Wahabi's will turn out to be Wannabe's. Orange Alerts may frighten investors, but remember, the devil you know is better than the devil you don't.

Which brings us to oil—part tree, part forest. The tree part is that there is a "terrorism premium" in this high price, some oil traders say, of as much as $10 per barrel. The threat of supply disruption has forced the US to build up a 3 months' Strategic Petroleum Reserve, depriving supplies from consumer markets. But the terror threat is finite and so is the temporary premium.

George Carlin, the brilliant comedian, says the only thing he remembers from his college economics course is "supply and demand." That's really all there is. Brilliant oil geologist, M. King Hubbert, predicted in 1956 that world oil supply would peak in the '90s forcing prices higher. This became known as "Hubbert's Peak." But then there's also "Herbert's Peak", named after one of us, which deals with the demand side and postulates that the high oil price will in due course force rationing and substitution too. Herb remembers the Arab oil embargo of 1973, when President Jimmy Carter, urged us to lower our thermostats and wear sweaters. And we did. Herb even fondly remembers his brown cardigan and his diesel car, and the ease of finding places to fill it.

In many matters, but especially in economics, necessity is the mother of invention. So get ready for more oil substitutes: solar, wind, natural gas, fuel cell, hybrid, diesel, nuclear and the accelerated development of the Canadian tar sands. Also, look for better insulation; lighter, smaller and more fuel efficient cars; fewer plane flights, but higher loads; lower speed limits and car pools; electricity conservation and work from home. Heaven only knows what modern technology, which gave us the Internet, can do in the alternative energy field.

Though we're currently in cheap oil stocks which are coining it, we're looking to hedge a correction in the oil price by shorting other expensive stocks in the group. On the other hand, we're always on the prowl for investments in the alternative fuels area, such as uranium, though it's been hard to find good values.

We're keen on *Canadian Superior Energy* and its potential for a huge gas discovery offshore Nova Scotia. We have also invested recently in *Delta Petroleum*, a US gas exploration and production company, drilling deep gas in the US Rockies, looking for huge pools with drilling technology that didn't exist 2 years ago. We think the company can add huge reserves and, though its price has risen smartly this year, is very cheap based on next year's estimated earnings.

Maybe the price of oil will peak soon and decline somewhat. It would be better for the world economy if it did. But our holdings, with growing production volumes and earnings, would still be cheap even with oil prices $10 lower.

Colour the Forest Green

The market correction may soon be over, perhaps by the time you receive this missive. The market is very oversold using our measurements: put/call ratios, McClelland Oscillator, TRIN Index, ARMS Index, relative strength and the like. Volume picked up on August 5th and 6th indicating a potential climax, or panic decline. Short sales by specialists (the professional market makers who are usually right) at 22% of total shorts is at the lowest level in 43 years, while the odd lotters, usually wrong, have stepped up their shorting to levels which have marked significant bottoms. Some of our smaller cap core stocks, like *La Senza*, are getting harder to buy as offerings dry up, a good sign. Investors are getting bearish, a positive sign, and insiders have lessened their selling and stepped up their buying. Cash on the sidelines is building and whatever liquidity is needed to arrest the decline, the Fed will undoubtedly provide. In hindsight, the correction will have been a mere tree. The forest will be the confirmation of an ongoing bull market in which the recent pullback will be seen to have been a buying opportunity. There are no bad bears in this forest.

We now own some tremendous values. In tech land, UTStarcom, *Nextel* and *SanDisk* all deserve to trade at 20 plus multiples, yet they've dropped to 8x, 11x and 11x (ex its cash) respectively. These companies are all market leaders with solid profit margins, superb growth rates and very high pretax returns on capital (64%, 46% and 179% respectively—the median for the Dow is 35%). In the most recent quarter, Nextel grew its revenues by 29% and its operating profits by 25%—stellar results. UTStarcom grew its revenues by 99% and earnings by 10%. And SanDisk had 85% and 71% revenue and earnings growth. Conexant, our big loser, trades at 10x expected earnings which should ramp up materially as expenses are eliminated after its post-spring merger and revenues climb as Internet connections (through its microchips, it has enabled more Internet connections than all of its competitors combined), multimedia PCs and set top boxes proliferate.

We continue to stay overweighted in the golds and look for some gratification soon as they tend to seasonally improve in August/September. We continue to hold *Gold Fields*, *Etruscan*, *High River* and *Cambior*—all trading at reasonable prices relative to earnings and net asset values.

For our long/short accounts, our short exposure is down to about 10% as we've taken profits in positions that declined, such as Goldman Sachs and Red Hat, and reduced the overall weighting as the markets have fallen to buy points in our work.

Thank goodness for market fluctuations. As dyed-in-the-wool value investors, we always want to buy bargains. *Good* companies at *good* prices. Most of the time, it's slim pickings. It's not now. We're fully invested and have many more ideas than cash.

At the bottom of severe market declines such as now, you can sometimes buy *great* companies at *great* prices. Revenue at big US companies is still growing at more than 10%. Second quarter profits for S&P500 companies grew 25% over the same quarter last year and, despite the jobs glitch, corporate profits should outpace economic growth for the foreseeable future. When you can buy great companies like Microsoft and Intel and Coca Cola and GE and Disney and Berkshire Hathaway and other quality names at depressed prices, it's time to forage in the Blue Chip Forest. We're foraging. Problem is, we like what we own, so whatever we find has to be better.

We colour the forest green because that is what it looks like when it's blooming and because it's also the colour of money, which apparently doesn't grow on trees, but might be hidden in the forest.

Forest Rangers
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