

ELEMENTARY PHYSICS

September A Bummer

Whew. What a third quarter. Bad for us. Worse for most others, but that's no consolation. To put it in perspective, it was the third worst September quarter in the last 72 years, surpassed only by 1931 and 1974, and the fourth worst six-month period of that time. As for the entire bear market itself, this has been a brutal meltdown, with the TSE down 46% from its peak, the S&P down 44%, the DOW down 35% and the NASDAQ a whopping 75%. And markets all around the world have plunged as well, with the German DAX down 62% and the Nikkei at 19-year lows, down 77% from its peak 13 years ago. The current bear market is now the longest in 60 years and the deepest since 1938. Seven trillion dollars of household wealth invested in equities has disappeared since the peak of March 2000.

But markets don't go straight down. We turned bullish, too early, in July, based on valuation levels in our work only seen at bottoms and also based on bullish technicals. So we became fully invested. Not only did our new longs get hit, but our defensive holdings like golds and safe dependables didn't work their usual defensive magic. Everything went down in the capitulation. And the absurdly cheap ideas that value investors might think are impervious to further decline continued to sink, from redemption pressure on funds which drove many stocks down to nuttily cheap levels.

To compound matters we made some mistakes. We didn't trade enough to take advantage of the power of our work to cut losses and take quick profits in what proved to be a very volatile market where everyone was getting whipsawed.

October Rebound

October has provided some relief. After investor optimism in the US reached a record low in October (half the level of September), the market exploded up, driven by heavy short covering. October, which has usually been a poor month, turned out to be the second best October in history (the Dow up 10.6%, the S&P500 9%, and the NASDAQ 13.5%) and the best month since January 1987. The TSX, though, was up a mere 1.2%. This was the first winning month since the Spring. Was it just a bear market rally or something sustainable? We're not sure yet, but what we do know is that there's lots of value in the market and in our clients' portfolios. Though we were premature in our July call, our current conviction in the reward potential of our portfolios couldn't be greater. Not because we think the market will go straight up from here. To the contrary. It might go down again first to retest its low. Or even make new disgusting lows. Nor do we think the economy is out of the woods. We may be in for a double dip. The drop in capital spending in the US, now in its third year of decline, is the greatest since WWII, and the consumer who's been driving this economy with his spending may be running out of gas. US consumer confidence in October was at 9 year lows.

But like the three years of decline in business investment, the stock market is also in its third year of decline, a rare occurrence indeed. And, as a result, values are compelling no matter if the dreaded double dip occurs.

At the end of September, about 1/5 of all NASDAQ stocks were trading under \$1.00, threatened with delisting. There will be more reverse splits on the NASDAQ than the US Olympic gymnastics team. But, as we recall, the great John Templeton started making his fortune in the '30s buying a raft of stocks trading under \$1.00. And that was when a dollar was worth a dollar.

Actions Beget Reactions

We recall from our elementary knowledge of physics that Newton's Third Law of physics claims that for every action there is equal and opposite reaction. To put that into market context, we believe that for most of the economic problems, and political ones too, real and perceived, there are natural reactions which come into play to counter, offset and, sometimes, eliminate them. The opportunity in this for investors is that while the public focuses on the headline problems—the “actions”—it is not taking much account of the forces at work to counter those problems—the “reactions”.

To Wit:

A. Problem: Overcapacity

There was too much capacity created in telecom and technology during the bubble period, when capital was almost free. Prices cratered, profits disappeared and many companies couldn't compete.

Reaction: Companies, indeed whole industries, are cutting capacity, and some companies like WorldCom and Global Crossing are restructuring through bankruptcy. Much existing capacity has been idled and business investment has shrunk. Ultimately, maybe after some years, but probably sooner than we think, demand will cause capacity to be utilized to a greater extent, technology will render obsolete much existing capacity, margins will expand, as will the need for investment, and the cycle will start again.

B. Problem: Undercapacity

In many basic industries that were not in the New Economy and not caught up in the bubble, capacity has not grown to any great extent for many years because capital was diverted to hotter areas. Deprived of capital, the Old Economy has had a capacity shrinkage. Thus, Noranda trades at the same price it did 20 years ago. Who needs a new copper mine or smelter? During that period, Algoma Steel, Bethlehem Steel and others went bust.

Reaction: Algoma Steel, now out of bankruptcy, just reported its second straight quarterly profit citing stronger sales and better prices, and Dofasco just reported a record third quarter. Fertilizer companies, like Agrium, are prospering. Commodity prices are rising smartly and have likely started a new bull market after a 20 year bear. This will help mining, agriculture and basic manufacturing companies. It will now be their turn to prosper and their turn to add to their capacities. This is a group that has been out of favour for a long time, but represents good value. We'll be looking here.

C. Problem: Consumer Spending

With business spending in a funk, it's been the consumer who's been carrying the economy. Two-thirds of GDP is consumer spending. But his buying mood is understandably impacted by all the layoffs, the hit to his stock wealth, the threat of a war with Iraq, snipers in his backyard and his own high debt levels. At the recent peak, household debt got to 100% of the consumer's disposable income. Besides, he's already got enough housing and cars. Reports from giant retailer Sears and credit card provider Capital One of rising delinquencies in collections caused their stocks to crater and may be signalling trouble in consumerland. Auto sales keep trending down, and used car prices are weak, so auto companies have had to continue offering interest-free financing. Mortgage rates at 40 year lows have not only encouraged the consumer to buy a new house, but to refinance his existing house at lower rates so he can spend on other things. But is the consumer getting tapped out?

Reaction: The Fed will keep rates low so that housing continues to be affordable. Most important, consumer incomes are surprisingly robust. As consumer spending decreases, savings increase—fuel for future spending. Odds are, if it hasn't already, the stock market will soon stop going down, and with the rebound, consumer wealth will increase again, as will his sentiment. Consumer non-durables regularly need to be replaced and consumer durables become obsolete and eventually need to be replaced. Thank goodness for fashion designers who seduce us into replacing everything every season. We don't know if wide ties or narrow ties are in, but we do know that, at Strategic, we insist on the correct width. The auto companies even know how to plan obsolescence. Technology advances continue and will whet our appetites for faster PC's, better cell phones, DVD players, video on demand and the like. And who doesn't want a bigger house in a better neighbourhood? At least as big as the Joneses, especially these days when there's a belief that houses are a better investment than stocks. And when we get the house, don't we need to go to Home Depot for some stuff to repair it and to Ethan Allen to decorate it?

Isn't it amazing how with all these massive layoffs, unemployment still stays relatively low at only 5.7%? How low might it get in the recovery? How resilient must this economy be that it can absorb so many of those recently unemployed?

The point is that as soon as consumers replenish their savings and their confidence a bit, they will spend on things they need but deferred. But materialists that they are, they will also spend on many more that they might not need, but which they want and which advertisers encourage them to have. That's the North American way.

And if they need more help, the US tax cut will be made permanent and double taxation of dividends will be eliminated. If unemployment does get out of hand, government will "react" and spend what it needs to. Like Roosevelt. A "Newer Deal". Governments react, according to the political law of physics, which says if there's a problem, you'd better react if you want to be re-elected.

And then there are the Chinese. All 1.3 billion of them. China, now the fourth largest industrial base, competes the heck out of us—they make 50% of all cameras, 30% of all air conditioners, 20% of all refrigerators. Wal-Mart buys \$10 billion in goods from them. But

they are consumers too. As their standard of living rises, and that of other developing countries too, imagine the huge demand from these billions of potential new consumers. Every western consumer goods company is trying to sell to the Chinese. Believe it or not, Pringles and Frito Lay are going head-to-head in China trying to get the Chinese to eat potato chips, with Pringles apparently winning because the Chinese prefer the stacks. Honestly. And see if they think they can stop after they've had just one. This alone could cure the trade deficit. And wait until we teach them our national pastime, "Shop Till You Drop."

What can we sell the Chinese? Raw materials for sure. Technology, software, telecommunications and aircraft. Kimberly-Clark, Hurricane Hydrocarbons and CAE will be there. CryptoLogic for sure too.

Strangely, even though consumer sentiment is lousy and September retail sales were off 1.2% versus a revised 0.6% rise in August, in our work, many of the retail stocks look attractive. J.C. Penney just announced some better results citing improved jewelry and footwear sales. We know from our own internal intelligence (family members who are shopping experts), that Gap Stores has finally gone back to basics and is doing better and that Tiffany's is busy. We've just bought Abercrombie and Fitch again because it got so cheap, the kids love it, its returns on capital are great, it's got lots of cash and no debt, and it's just a question of when, not whether, growth accelerates. But at the same time, we're short Kohl's Stores, a growing department store chain that we think is overvalued. The computer sector, with the short life of its product, is showing life. IBM is doing better, Hewlett-Packard is forecasting a good holiday season, and Dell sees an improvement in US demand.

We are being selective. Sometimes, as in October, most stocks go up. In the September quarter, most stocks went down. Going forward, we think we will be in a stock picker's market where some stocks will go up, but lots will go down. Selectivity is the watchword. So, as in the case of the retailers, we will need to discriminate carefully between those with growing revenues and superior product offerings, which are financially strong with superior returns and trade at less than fair market value. And of course, avoid the opposite. There's a law of physics that applies here too—the Theory of Relativity that states not all stocks in the same group are equal, especially in an excessively competitive environment. It's all relative—to their specific fundamentals and valuations. And, similarly, different groups themselves need to be evaluated relative to one another and weighted accordingly. You don't have to be an Einstein to figure out this theory. It's plain common sense. And the SVA work we use helps us discriminate between groups and individual stocks too.

D. Problem: Excessive Debt

There's too much debt out there, owed by government (federal, state and municipal), corporations and consumers. As the economy slows, tax collections shrink and government budget deficits rise. Corporate growth slows, profits turn into losses and defaults occur. Banks and other lenders, with newfound religion, are reluctant to lend to the very companies that need loans. So even investment grade corporate bond yields now trade at a historically high premium to 10-year Treasuries. 10-year Treasury yields themselves recently jumped from 41 year lows of 3.58% to 4.26% in a one-week period. Junk bonds yield 14% with some telecom bonds yielding over 20%. It's justifiable since many junk bonds have

defaulted, 60% by telecom companies, and \$40 billion has been lost in telecom companies alone. In the last 2 years, over 80% of rating changes by Moody's have been downgrades.

Reaction: The Fed looks set to cut rates again in a couple of days making the cost of money cheaper. Annualized monetary growth is pretty high too, making money not only cheap but plentiful. Bankers may need to be cajoled by the Fed into making needed loans, but those wide credit spreads may prove to be enticing as well. Meanwhile, corporations are cutting costs aggressively in order to lower breakevens, and believe it or not, many of them will turn profitable and become creditworthy again, or growth in revenues alone can do the trick. Case in point is Nextel, one of our bigger holdings. Growth in revenues from its cell phone product with its unique walkie-talkie function recently started to surpass its costs, making the company, all of a sudden, fabulously profitable. On top of that, capital expenditure requirements are shrinking, so that free cash flow is enhanced. Nextel was the kind of highly leveraged company we'd normally avoid, but its potential for significant free cash flow generation has allowed it to buy back debt and preferreds, for common shares and cash, shrinking debt by \$2.6 billion over the last year.

Moreover, debt is only bad for companies that don't generate profits to an extent greater than their interest cost. When they do, leverage enhances earnings. When interest costs and share prices are as low as today, it's a prescription for buybacks and takeovers. We were recently told by a professional turnaround investor who specializes in distressed situations that there is more money out there today looking for distressed deals than deals to be found. A natural "reaction". Bottom feeding.

Maybe banks are fearful to lend, but when corporate bonds are yielding such a premium over treasuries, there is a powerful incentive to take on more risk for greater return even after allowing for a healthy percentage of defaults. A natural "reaction". Bankers' greed will out every time.

A weak economy needs fiscal stimulus so more government debt is to be expected and is acceptable. So long as there are buyers of government bonds, and there appear to be lots of them.

As for corporations, the ones that can service their debt will get through until the better times. The very profitable ones will retire debt out of free cash flow or refinance at lower rates, or if they can, and it makes sense, raise equity to repay debt. Those that can't service their debt will, unfortunately, see it liquidated through bankruptcy, restructuring or compromise, an ugly but natural process of debt repudiation that happens in every down cycle. Banks are reporting significant loan loss provisions, and on the other side of the coin, more than 60,000 US companies have sought bankruptcy protection since the beginning of 2001. As one of our colleagues points out, Chapter 11 reorganizations are a great boon for beleaguered US companies that allow them to carry on business and even compete more effectively without debt service and oppressive contracts to worry about. So Global Crossing, WorldCom, US Airways and K-Mart are still in business and competing hard.

E. Problem: Deflation

There is a notion in vogue today that a general price deflation is taking hold and that it will drive us into depression. Clearly, in this slow global economy, many companies don't have

pricing power. And consumer prices in some areas, such as computers and telecom are falling. Deflation is anathema to a debt-ridden economy.

Reaction: While we agree that debt and deflation are a dangerous combination, we don't see deflation as an outcome unless the Fed makes a policy blunder as was made in the '30s. The Fed may not like inflation. Actually, it likes a little bit. But it loathes deflation. So count on it to reflate. Big time. Plentiful and cheap money. Big time spending by government for infrastructure and defence. When was there ever deflation in a war economy? If price stability needs it, there will be import taxes and barriers and limits on immigration. Because of double-digit printing of dollars and a scary current account deficit and interest rates too low to be attractive to foreign lenders, count on a declining dollar, an automatic inflator because import prices rise. Oh, and by the by, while a declining dollar may hurt share prices in the short run, it will greatly enhance the earnings of US multinationals and manufacturers which compete with imports.

Also count on higher oil prices no matter if the US does get to control Iraqi oil. We're just not replenishing reserves. Commodity prices generally are already rising. The CRB index, at 229, is near its recent high. The grains are up. Cheerios are sure to follow. Coffee and cocoa and sugar are up. Cappuccino's next. Copper at 72 cents per pound, up from 65 cents, is a barometer of things to come. Gold and silver are next. Deflation? If the psychology shifts, there just might be a run from cash into real assets. Real estate prices are already high. So are art and collectibles. Deflation? More likely stagflation. Maybe computers and telecom prices are getting cheaper, but housing isn't, nor services, nor food, nor energy. Insurance premiums are significantly higher. The cost of health benefit plans is expected to increase 15% in 2003. Interest rates may be low, but the yield curve is very positively sloped, not a sign that bond investors are betting on deflation.

As value investors we need to be contrarians. Contrarians need to guard against what's the generally received wisdom. If investors are worried about deflation (consumers sure aren't) then you can expect "reactions", policies to deflect it. Like Lola, "Whatever the Fed wants, the Fed gets", and sometimes then some. Look for a "reaction" to the threat of deflation. In fact, guard against the potential for an overshoot. Much higher inflation.

Even Japan, we think, is finally addressing its deflation. When they reverse it, their consumers will start spending their enormous savings. Good for Toyota and Honda and Sony, which appear to be coping just fine anyway.

F. Problem: Extreme Pessimism

Physicists talk of black holes in the universe. Well, many commentators would have us believe the economy and the market are going into a black hole now. That we're in a Grand Supercycle Bear. Bill Gross of Pimco, the huge US bond fund, thinks the Dow is headed to 5000. Robert Prechter, the Elliott Wave guru, thinks Dow 1000 is a possibility.

Reaction: We think these are extreme views that always come to the fore at extreme points in the market. Remember Abby Joseph Cohen, Henry Blodget and the two guys who wrote "Dow 36000" at the top in 2000, or Ravi Batra's best seller "The Great Depression" at the bottom of the 1990 bear market.

This isn't a black hole; it's a dark tunnel with light at the end of it. Layoffs continue and costs get cut until bankruptcy or sustainability. But, one way or another, be assured there is an end. We suspect most of the bloodletting has already occurred.

It has always been a mistake to take an apocalyptic view of things. The US economy has always proved to be resilient. Warren Buffett says, "You can bet against the market, but it never pays to bet against the US economy." As a market economy, natural forces kick in to react in downturns. Savings rates increase, debts get liquidated, costs get cut, margins improve, losses are eliminated and earnings eventually turn up and, with it, share prices and confidence. It was always thus.

Now overlay on the free market, on the so-called "invisible hand" that economists talk about, the levers that government and central banks have to stimulate recovery, and you have a powerful combination.

Look for positive surprises. The market's not expecting anything good. Maybe the war on Iraq won't happen. Maybe Saddam will quit. Or the war will be over quickly. Maybe the pro-business Republicans will get control of Congress. Interest rates might go lower. Or look for the market to go up in the face of bad news, like it did last week after a negative Chicago Purchasing Managers' Indicator, or even during a period when mutual funds are still getting redeemed, like in October.

The news is not consistently bad. While industrial production and durable goods orders fell in September, perhaps affected by the dockworkers' strike, housing starts surged 13.3% in September to their highest level since 1986.

But the big story, we think, is how strong personal incomes have remained and how low unemployment has stayed. One of our favourite market strategists, Don Hays, expects the economy to start looking much better with a better than expected Christmas because real after tax incomes are strong (growing at a 6.1% rate), the consumer is paying off debt and the one-year lagged effect of the Fed's interest rate cuts are now starting to kick in.

How about that Microsoft ruling? And aren't the terrorists on the run? Their leaders are hiding. Their funding is drying up. Their further actions in Moscow and Bali only serve to expand and unite the powerful forces against them.

The best thing about pessimism is that it creates opportunity. Especially when it's exaggerated. While we need to deal with client anxiety (you know who you are), we actually get calmer near bottoms because obviously the risk is diminished. An important law of physics is the Law of Averages, and when we suffer such an extraordinary decline, the Law of Averages, which states that there's a huge bias in favour of mean reversion, is on our side.

We don't think we're looking at the world through rose-coloured glasses. In fact, we anticipated many of these current problems in our past quarterly letters, but now that they're exposed, one way or another there will be corrective "reactions". It's a natural process. Short-term pain for long-term gain.

G. Problem: Earnings and Valuations

We continue to hear that the market is still expensive based on high p/e ratios, low dividend payouts and expected lower earnings.

Reaction: Guess what, there may be no pricing power, and the recovery, so far, may be anemic, but there already is an earnings revival. With 134 of the S&P500 companies reporting through October 16, operating income in the third quarter rose by 11.1%. Sales only rose by 3% so margins were improving through cost cutting and operating leverage. All we need now is more demand and greater capacity utilization and watch out. More Nextels. Maybe there's even hope for Nortel.

We don't think valuations are at all high, based on forward consensus earnings estimates and the current low level of interest rates. In fact, we think the market is cheap. Better still, we think many individual stocks, including the ones we own are incredibly cheap. Sure there are a lot of sick companies out there that may not make it, like Lucent and United Airlines. So what. Most of the ones we own are trading at single-digit earnings multiples, most have very strong balance sheets, and most are on, or should soon get back to, a healthy trajectory of revenues and earnings. Maybe some, sympathetically, will sell off a little in any further market correction, but it shouldn't matter too much because their upside potential is far greater than any downside risk. In fact, we think many of our stocks can double over the next 2 to 5 years. These include Nextel, Hurricane Hydrocarbons, CryptoLogic, Pan-Ocean, Northgate, High River, Newalta, CAE, Abercrombie and Fitch, Safeway and others. And if nobody else is there to buy our stocks, the companies themselves will, since most of them have share buyback programs, a sign of strength and cheapness.

Science and Art

Being successful in markets involves part science, part art. The art part involves using common sense: diversifying, weighting groups and stocks appropriately, avoiding undue risk, anticipating intelligently and reacting to unexpected developments. The science part, not exactly Quantum Mechanics, involves valuing companies by examining tried and true criteria: book value, net asset value, debt to equity ratios, earnings reliability, price to earnings ratios, free cash flows, quality of management, growth rates, competition and so forth. It also concerns gauging the psychology of markets to determine when they're overdone, going up or going down to anticipate reversals. And knowing, that as in the case of the bubble, the market was like a balloon full of hot air (like those pundits who were predicting its continual rise) which couldn't rise indefinitely without bursting. And knowing, conversely, that according to Newton's Law of Gravity, the market then had to fall like a lead balloon. Lots of money made and lots of money lost. But, for most of the time, the market is more like a rubber ball just bouncing along. And lots of money can be made in those up and down bounces.

President Bush acknowledged recently that the economy was "kind of bumping along". We'll settle for bumping along, while all the "reacting" is ongoing, the economy gathers strength and investors gather conviction. There may be no limits to the universe, but every physicist worth his salt will tell you there absolutely will be an end to this bear market. The number of shares available for purchase, the "trading float" has shrunk materially through stock buybacks and takeovers (and hardly any IPOs) while the trillions of dollars of cash parked on the sidelines,

available to buy that float, grows. Moreover, the value of that float has, obviously, dropped too. Remote perhaps, but the potential for a buying panic if that mountain of money chases a dwindling float. What would that do to confidence? And underfunded pension plans? In the meantime, there will be lots of opportunity to successfully trade mispriced stocks. Just as sure as $E=mc^2$.

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