HIGH WIRE ACT

Performance wise, we have just come off an excellent September quarter. October was terrific too. Nevertheless we're worried. Not necessarily about our portfolios, though we may not escape unscathed in a market decline. Because our holdings consist of very undervalued stocks, good income securities, cash, golds and overvalued shorts, we feel our portfolios are reasonably defensive and not particularly vulnerable.

The Good News Bears

The economic news couldn't be better. GDP growth for the September quarter surged to 8.2%, the best quarterly increase in 19½ years. Corporate earnings also have been coming in stronger than expected, up a 10.6% annual rate of growth in Q3; interest rates have stayed low; there's a ton of liquidity in the system; deflation talk has been muted; inventories are low and will need to be rebuilt; housing sales and prices have not faltered and recently, the pièce de résistance, an improvement in the employment picture. So why are we worried?

Bonds look risky and cash yields nothing, but equities, the investment of choice, keep moving higher, and even our SVA™ work suggests that the stock markets are likely to move even higher before correcting. So why are we worried?

The news is good. Markets are good. Bullish sentiment is high. Confidence is improving. Even better times lay ahead, we're told by the media economists. It seems obvious.

We're worried because, as market guru Joe Granville used to say, "The obvious can be obviously wrong."

Illusions

We're concerned that what you see may not be what you get. Yes, the economy in Q3 was very strong, but it was influenced by monetary ease and ultra low short-term interest rates—rates rarely seen before. By government spending which accounted for some 40% of Q1 and Q2 GDP growth. And by huge fiscal stimulus. By 40-year lows in mortgage rates which allowed consumers to overborrow on their houses for general spending and by 0% auto financing which gave that sector an extraordinary boost. We're worried because the tonic of all that stimulus to cure the ills of the prior slowdown has side effects that are equally harmful.

The information contained herein has been drawn from sources which we believe to be reliable; however, its accuracy or completeness is not guaranteed. This report is not to be construed as an offer or solicitation to buy or sell any of the securities herein named. The inventories of Strategic Advisors Corp., its officers, directors or shareholders may from time to time include securities named in this report. E. & O. E.

Moreover, while unemployment had a downtick—modest compared to previous recoveries—manufacturing employment continues to weaken and is at the lowest level since the 1950s. In fact, job cuts in October were up 125%, the highest since last October's 176,000. The consumer has been carrying the economy for almost 4 years. But while government spending was out of sight, and business and consumer spending were higher too, consumer spending actually fell 0.3% in September (and is unchanged in October), after rising in July and August, and real disposable income (after taxes) declined 1.2% once the effect of the tax refunds were gone.

In fact, despite all the good news, the most knowledgeable investors about their own companies, corporate insiders, have been selling far more stock than they are buying.

All of this, we think, is still fallout from the stock market bubble, a 3 ring circus indeed, which was followed by a ferocious tiger of a decline requiring the biggest tiger taming act of all time—dare we say it, a credit bubble, led by 13 interest rate cuts, three tax cuts, huge government spending, a massive growth in money supply, a campaign to lower the dollar and, now, even some protectionist measures. The result—debt to GDP is at a record high. We're concerned this tiger may have Fed Chairman Greenspan by the tail. Some tigers are unpredictable and hard to control. Just ask Siegfried and Roy.

Debt Reckoning

We have lots to worry about: a massive trade deficit, unemployment, underfunded pension liabilities, quality of earnings, terrorism and so on. But our major worry, by a country mile, is the unprecedented level of debt. Historically low rates and high liquidity have naturally induced spending and borrowing that caused excessively high debt levels for households and business, not to mention margin debt even higher than when the NASDAQ was at its peak in March 2000. The assistant chief economist at National Bank notes, "Never before have US households been this leveraged at the start of an economic recovery." Government spending, exacerbated by a war, multiple tax cuts and lacklustre tax receipts, has caused outsized deficits to add to a mountain of government debt. All this massive leverage in the system, induced by interest rates as low as they're going to go at a time, in fact, when they are more likely poised to rise. Britain and Australia just raised their rates. Ringmaster Greenspan is hinting the US may follow suit soon too.

To boot, excessive consumption and low savings rates caused record trade and current account deficits which are putting pressure on the dollar. Interest rates are set to go up anyway, but a declining dollar may exacerbate their rise as foreigners (who own almost half of all treasury debt) avoid and even dump US debt instruments. Rising interest rates are anathema to an overleveraged economy. They are a prescription for lower house prices as rising mortgage costs would pressure affordability. They would shut down the mortgage refi market and consumer spending would hit the wall. They are naturally a killer for bond investors. And, ultimately, will pressure equity valuations too. The tiger act is sometimes followed by the dancing bears.

Walking a Tightrope

The Fed is walking a tightrope. Ringmaster Greenspan knows all that we know, and then some. He knows that debt levels are out of sight and rising. That, in only five years, total financial and nonfinancial US debt went up over 50% to more than $32 trillion, 3 times GDP. That households added almost $400 billion in mortgage debt and $40 billion in credit card debt in the celebrated September quarter. And that, in a nation of poor savers, a lot of US debt is held by foreigners. He knows that interest rates have nowhere to go but up, and if they do too much, too fast, it could result in asset deflation, especially of overpriced houses, in a deluge of bankruptcies, in wealth destruction, in reduced consumption, in a poor equity market and in an economic slowdown, maybe a severe one. And if the US, the engine of the world economy, slows down, despite a lower dollar, the rest of the world will slow down too, especially because of a lower dollar. If Ringmaster Greenspan is smart, he'll soon ask for his retirement watch, especially while gold is good.

What policy options does the Fed, as a concerned tightrope walker, have? Mainly, the Ringmaster is keeping the monetary spigots open, hoping that enough liquidity, continued low interest rates and a cheaper dollar will allow the US to become more competitive and debt service to be manageable, but, especially, will create enough inflation so that debt as a percentage of inflated asset prices will be diminished and can be more easily repaid with cheaper dollars. He's depreciating debt in terms of purchasing power. Screw the lender. Screw the saver. Save the borrower. Above all, buy time. Time to reflate. Time to liquidate the bad investments of the last boom in an orderly fashion. Time to repair balance sheets.

And, in a sense, it's starting to work. Debt liquidation. Bankruptcies are at record levels even as the economy strengthens. Layoffs continue so productivity improves. Restructurings and mergers to create more competitive entities are announced daily. And importantly, asset prices are going up. Commodity prices have been strong, thanks also in part to Chinese demand. The gold price is nearly $400. Prices of collectibles have soared—5 records were broken at a Sotheby's Canadian art auction we attended last week. House prices continue to stay strong. Bond prices continue to weaken and the US dollar looks precarious indeed. And, for sure, the stock market is benefiting from a flight from cash.

Correctly so, because "cash is trash." It earns little and its value is depreciating. At around a 1% return, a saver is getting a negative rate of return, less than the rate of inflation, especially after taxes.

Keeping Its Balance

But wait, the growth of M3 money supply (the broadest measure) recently collapsed because banks have been losing deposit funds they use to lend to business or to buy Treasuries, as depositors abandon low yielding deposits and money market funds to seek the currently better returns from stocks. Oops, the Fed might need to shift its weight on the wire. Or, look out below! Maybe get ready to buy bonds directly, or open the Fed borrowing window wider for banks to continue to borrow cheaply and plentifully. Or whatever. But keep the liquidity up, no matter what. Or else. In such an environment, where the Fed is clearly walking a tightrope, what's a mere portfolio juggler to do?

Sometimes Macro Matters

It was recently reported that Bill Miller, star US manager, says his team doesn't look at macro factors. Well, we might agree that they're usually too difficult to forecast and therefore might cloud investment judgment at most times. But these are not most times—this is a highly unusual period. We know it's unusual when the Canadian buck is up an astounding 20% so far this year.

So we note that, even if the reported news is good, there's lots of unusual macro risk as a backdrop for investing. Inflation risk. Interest rate risk. Currency risk. Business risk. House price risk. Stock market risk?

In short, the monetary environment is unstable.

Bill Miller might think macro management is not important, but guru Warren Buffett is telling us that, for the first time ever, he's investing in foreign currencies and sitting on $24 billion in cash because he can't find anything to buy including bonds. Sage, John Templeton and money management stars, Jeremy Grantham and Bill Gross, are warning of potentially bad times ahead. Jimmy Rogers likes commodities better than stocks. Economists Stephen Roach of Morgan Stanley and David Rosenberg of Merrill Lynch are cautious. Worrywarts all.

Worrywarts

We're worrywarts too. So we are also on a tightrope trying to play safe and still get a rate of return. Risk avoidance is what we think about first and foremost. We only want to own what's low risk/high reward, and avoid what's high risk/no matter the reward, according to our view of what's risk. Any self-respecting tightrope walker or portfolio juggler looks down before he looks up. So we don't own long bonds. After 20 years of a bull market in bonds, they're likely low reward. We want to keep our investments mainly in Canada so that our Canadian clients avoid currency risk. We're also cognizant that Canada and other exporters to the US may suffer as the US dollar declines.

We continue to hold 15-20% gold stocks, 25% oil and gas stocks, seek other resource stocks that will benefit from the reflation play, want cheap stocks that are not economically sensitive and companies that are strong enough to withstand any downturn and can grow their earnings in almost any environment. Healthcare, biotechs, pharmaceuticals, or multinationals that can benefit from a declining dollar. *CryptoLogic* because people will gamble online no matter what. And companies that are not market sensitive. *Goldfarb* and *SMK* which are in liquidation mode.

We hold some income investments in the form of lower risk income trusts or medium-term, high yielding debt instruments. Our shorts are about 20% of the long/short portfolios to protect the downside. If we're wrong, as we're prepared to be, we'll make less. But losing is what we're always keenly trying to avoid. If Ringmaster Greenspan slips up and the Fed falls from the high wire, we don't want to be standing under it. "Splat" is not a sound portfolio jugglers want to hear.

Concerned as we are about the level of consumer debt, we don't own much in retail. Even mighty Wal-Mart reported below expectations and its President noted, "Consumer spending is slowing, but I don't see the strength that many of you in the investment community appear to see. We're still seeing a cautious consumer…who is timing their expenditures around the receipts of their paycheques, indicating liquidity issues." Imagine if mortgage rates rise?

Notwithstanding, we're keen on lingerie and sleepwear chain *La SENZA* because it sells basic goods, has a strong balance sheet, has a dominant share in Canada with over 200 stores, and licenses its products internationally to 150 stores in 13 countries. The company is growing its square footage by 10% in Canada, vigorously pursuing growth overseas and has incredible growth potential in the US where it just opened its first 5 locations. This very profitable company trades at a bargain price—its multiple of earnings is only about 6 times once the excess assets (cash and holdings in Wet Seal, a US publicly listed retailer) are excluded. We can see $18 within a year (a 35% gain) and growth at a reasonable double-digit rate thereafter. As a footnote, La SENZA is where the tightrope walkers pick up their tights.

Kingsway Financial Services is a new addition to our portfolios. This Canadian company is a specialty insurer serving lines like nonstandard auto, motorcycle and trucking, mostly in the US. It's one of the few P&C insurance companies that have consistently earned a significant underwriting profit. Kingsway's share price corrected recently as it took additional reserves, mainly because "no fault" insurance in Ontario and some extraordinary litigation in Florida caused a temporary increase in claims. The company implemented fraud controls in Ontario and the Ontario government has also enacted preventive legislation. Loss rates appear to be declining and premiums are up. At 6 times earnings, Kingsway is very cheap. It can grow by 15-20% per year and should carry a multiple twice its current one.

CAE has likely just completed what should be its last poor quarter before a significant recovery. The commercial simulator market, in which it has a dominant share, is on the rebound and the regional airlines, CAE's customers, continue to fare well. Its military business is thriving and some big contracts should be won in the next few months to combat the maturing ones. The training business, an annuity business, because pilots must be trained twice annually, is growing and utilization rates continue to improve. The company has repaired its balance sheet via sale and leasebacks and a recently completed equity issue, but also from its free cash flow which should continue to build after three years of burning cash to build the training business. CAE should earn over $.60 in its next fiscal year (ending March `05). At a more reasonable multiple of earnings than the current 9 times, such as, say, 15 times, the stock could trade to $9 and we believe years of growth are ahead. Furthermore, we would not be surprised if a US or European company acquired CAE—one of Canada's last remaining high tech powerhouses.

Among the few US stocks we currently hold is *Laboratory Corporation of America*, the second largest clinical lab testing company in North America. The company is a steady grower and should continue to grow its earnings strongly, especially with the advent of newer more esoteric testing (e.g., genetic tests). Lab Corp. trades at only 14 times next year's earnings—a discount to its Fair Market Value, which we think is closer to 20+ times earnings, and in the meantime, we expect the company to grow at a 14% annual rate.

Pan-Ocean continues to perform well. It is about to report its Q3 results and we expect that, despite some recent production glitches, earnings and cashflow will still be on track and that the stock is headed higher. An offshore Gabon exploration well will be spudded this quarter and an expensive offshore development well next quarter which could add significantly (30%+) to oil production. The company has also announced a joint venture of an onshore Gabon field with Shell which again could add value. This continues to be an underfollowed, cheap (6x earnings), growth story which could double again over the next 3-4 years.

Petrokazakhstan, another very cheap oil stock (5x earnings) has come off recently in the face of some antitrust claims by Kazakh regulators. The company dismisses these as unwarranted and immaterial, but against the backdrop of the Russian Yukos oil company imbroglio, it has made investors in the region unduly nervous. The company, which generates significant free cash flow, has said it will soon either make an acquisition, buy back some shares or pay an extraordinary dividend. Another buying opportunity.

Canadian Superior is an oil and gas production company, growing from its production in Drumheller, Alberta, with a $3.50 price target absent any significant discoveries. However, it recently announced an acquisition of significant prospective properties in Trinidad and will be drilling a high impact play in East Ladyfern, Alberta. Driving the stock near term is the recent spudding of a $40 million gas well offshore Nova Scotia with El Paso, the deepest well to be drilled in Canada, in which Canadian Superior has a 50% interest. If successful, the stock could jump materially in early `04. If not, we could get a temporary price decline, but which is outweighed by the upside potential.

As one would expect in this environment, gold bullion and gold stocks continue inexorably higher. If they're paying record prices for Group of Seven paintings, they'll soon be paying record prices for gold, the ultimate commodity, the ultimate currency, the ultimate store of value, the ultimate safe haven.

We traded out our *Northgate* because it was approaching its target and we were concerned that the rising Canadian dollar would negatively impact earnings. We hold smaller caps *Etruscan* (gold and diamonds), *High River Gold* and *Rio Narcea*, closed end fund *Dundee Precious Metals* and large cap *Gold Fields*, all of which we think are good values. In certain accounts, we also hold *Iamgold* and legacy positions *River Gold* and *St Andrew Goldfields*. The prices of all these stocks should go higher as bullion does. On the other hand, because gold stocks tend to correlate negatively with the stock market, they represent our "short sale proxies" in our long-only accounts to mitigate any decline. A worrywart's insurance.

In summary: we're worried; we're cautious; we're diversified. We're continuing to pick what we think are very cheap stocks in sectors we think are less vulnerable. And we're using the SVA™ work to guide us.

A student of the human circus and a great clown himself, Will Rogers, once advised, "Don't gamble; take all your savings and buy some good stock and hold it till it goes up, then sell it. If it don't go up, don't buy it." Our philosophy exactly.

Herbert Abramson and
Randall Abramson, CFA
November 24, 2003