

Pound Wise Penny Foolish

Investment managers need to have many avocations: mathematician, economist, psychologist, lawyer, corporate financier, ethicist, salesman, business evaluator and soothsayer. We try to encompass all those skills. But, most of all at Strategic, we're dyed-in-the-wool opportunists, not conventional modern portfolio theory adherents. Theory be damned, we go where we think the money will be treated the best. Where superior value may reside from time to time.

By reviewing the potpourri of holdings in our portfolios one might not be able to glean our investment style. Bottom line, we are alpha investors. We seek positive returns even if the general market is down. That's tough in a bear market, since most stocks go down in the bears, which is why we advocate long/short accounts both as a hedge but especially to take advantage of down markets through short selling. Then too, when we're in bearish mode from our own market timing and valuation capabilities, we endeavour to be less exposed and to be in securities less correlated to the market.

A Penny For Your Thoughts

We don't agonize about defining our style and don't want to be pigeonholed in any restrictive mode. We're sometimes criticized by our clients for much of what we do, especially when we're losing. Not much criticism in September, thank goodness. But we often get: "Too much concentration—don't put all your eggs in one basket." Or, "Too much diversification—why not concentrate in the best ideas—put your eggs in one basket and watch the basket closely." "Sell the winners—nobody ever got hurt taking a profit." "Keep the winners; water the flowers, prune the weeds." "Buy quality—banks are always good." Those adages are often right, but often wrong. You just can't win by slavishly following any one of them. You have to be disciplined, but flexible too. Opportunistic. What we do is part science, part art. And fluid—sometimes we diversify, sometimes we concentrate—sometimes we do different things for different people depending on original cost, different mandate or tax consequences.

We are risk averse—which doesn't mean "riskless". In the investing business where the goal is to achieve returns better than risk free securities (which these days are also virtually return-free), some risk of loss is necessary, but it's always measured against potential return. Our objective going in is to accept a moderate risk against a significant potential gain. And we try to avoid torpedoes with a stop loss derived from our SVA™ work, which often works, but not always, as for example in the case of volatile tech stocks when outsized losses occur too quickly to allow us to react. Conexant was such an example.

It's said that no money manager ever got fired for owning IBM, Big Blue, which means if optically the portfolio is populated with recognizable high powered big cap household names, well, they must necessarily be good quality, safe and not speculative regardless of underlying valuations. Conversely, lower priced unfamiliar medium and small cap names must imply risk and be more speculative. Even securities regulators have bought into this notion of big is good

and small is bad. But logically, what has the price of a share or its total capitalization to do with whether the share price represents good underlying value? A small cap company can have a good business franchise, growing earnings and cash generation, an excellent balance sheet, smart management and be undervalued. We want to buy low and sell high. Regardless of price. Buying low, even for pennies, doesn't imply we're flipping coins. The real flip of a coin is hoping your high priced stock doesn't miss its earnings estimate by a penny. When it does, look out below. Pennies from hell.

All Things Are Not Equal

We do recognize that there is some merit to owning bigger companies per se. All things being equal, "bigger is better". Bigger companies typically have bigger market shares; better "moats" to discourage competition; better financing ability; better analytical coverage; and higher multiples from the more stable growth, the higher institutional ownership (the indexers have to own them) and the desirability for the dividends the mature companies usually pay out. From our standpoint, most of all, big provides liquidity, easy to get in, but even more important, easy to get out.

So when we can buy bigger for not much valuation premium to smaller, we usually do. The big ones are so visible that when the misconceptions depressing them fade they tend to rally faster.

But all things are not equal. And, in recent times, big has been no guarantee of safety. Think about it. The mind boggles. Nortel, which only 4 years ago, during that memorable millennium celebration, constituted 1/3 of the entire TSX index, in short time dropped to less than half of 1% thereof. And, of course, many other highly capitalized big tech names bit the dust too. Cisco, JDS Uniphase, Lucent, Nokia, Oracle. In prior years, former Nifty Fifty members like Xerox and Avon struggled to regain membership. Some like Polaroid disappeared completely. And then, of course, there were those big cap stalwart frauds, Enron, Worldcom and Adelphia. Or questionable Fannie Mae and Freddie Mac. Or Marsh & McLennan, AIG and many of the mutual fund companies that got Spitzered. The Shifty Fifty. Or a multitude of disappointing "blue chips". Coca Cola ("the pause that refreshes" but makes you need vodka), Hewlett Packard, AT&T, Time Warner, General Motors and Ford, Unilever, Honeywell, Disney, Merck, Sears and Kmart (recently recovered as real estate liquidations) and low flyers AMR, Delta and UAL.

Big is clearly not foolproof. Sometimes the bigger they are the harder they fall. And, when the mutual funds are being redeemed, it's frequently the big liquid names that get dumped first.

We keep saying we go where money is treated the best. If it's to be in high yielding fixed income when stocks don't work, such as during the early 1980s, we'll be there. If it's to be 40% short ridiculously overpriced Dot Com stocks during the spring of 2000, we'll be there. If it's to be in energy stocks that are quickly growing their reserves at low finding costs when the price of the commodity is soaring, you better believe we'll be there. And if it's to be overweight gold stocks during a full-fledged commodity bull market when the US dollar is falling and looking precarious indeed, we'll be there.

Remember, above all else, we're unabashed value opportunists. And if medium and small cap stocks offer substantially better values than their large cap brethren, that's where we'll be, notwithstanding the trade-off of constrained liquidity. Indeed, because some of our smaller cap companies have recently outperformed, so has our overall performance. We believe that the scale of our firm is still to the advantage of our clients in allowing us to own the smaller cap gems we're able to ferret out.

Acorns to Oaks

We can't remember whether it was John Templeton or Martha Stewart or Randall's late grandfather who said, "Oak trees grow from acorns." Not all acorns. Most get picked off by squirrels. But, in market terms, sometimes small caps grow into oak trees. In fact, apart from spin outs, all big caps were born as small caps. Blue chip IBM was a small cap in the '60s. Intel was a penny stock in the '80s. Gold giant Barrick was a penny mining stock in the '80s. But small caps should outperform. They are typically the most innovative companies with the highest growth rates, but are often undervalued because they're ignored, unknown, under followed and under owned. In the last 12 months, the Dow Jones Industrial Average is up 6%, the S&P 100 up 7%, the S&P 500 up 11%, the S&P mid-cap index up 11% and the S&P small cap up 17%. Clearly, for the last year, bigger was not better. Nor generally has it been for any extended period. Opportunists look for market inefficiencies that create mispriced bargains. These are usually in the least analyzed stocks. According to The Wall Street Journal, the 100 most covered companies in the S&P 500 have an average of 22 analysts offering earnings estimates and trade at 26x the average consensus estimate. The 100 least covered ones average 7 analyst estimates and a price/earnings ratio of just 19.

We believe professional investors often have an edge investing in small caps, in that they can interface directly with managements. Clearly, IBM's CEO isn't coming up to our office. In the case of big caps, we need to rely on third party analyst information and investor relations personnel. Whereas the managements of our smaller holdings speak to us regularly. Moreover, because of our relatively large shareholdings, we can also often influence smaller companies to protect shareholder interests. Even to encourage a management change or a takeover or merger as an exit. Smaller companies are simpler stories and have fewer moving parts to analyze—unlike, say, GM and Ford which are supposedly auto manufacturers, but make most of their money from mortgage lending. Understandably, it's easier for a smaller company to increase in value and potentially achieve our return objectives than a big company which already has a multibillion dollar capitalization.

For example, in our holdings, *Petrokazakhstan*, now a mighty oak, which we just sold, started off as an acorn in 1999. Our current biggest holding, *Pan-Ocean*, on its way to oakdom, was an acorn in 2001. With a market cap now pushing \$500 million, the outlook for Pan-Ocean is still superb. Last week, Pan-Ocean and its joint venture partner, Shell, announced yet another oil find in Gabon, which likely added about US\$5 to the value of the company. This on top of its previous 100% owned discovery which added as much as US\$10. We believe the company's appraised value today is at least 40% above today's stock price. Based on what the company has already discovered, it could grow its production from 10,000 to 30,000 bbls/day over the next 2-3 years, with continuing significant exploration and development potential onshore and offshore Gabon.

Pennies From Heaven

We often find smaller cap companies whose current valuations and future prospects are compelling opportunities. We currently hold a few smaller oil and gas producers. *Rally Energy*, which is producing about 2,900 barrels a day of heavy oil in Egypt, should grow its production by 50% in the next year and trades at only 2x 2005 estimated cash flow. *Canoro Resources*, whose properties are in India, trades at less than half of net asset value with the prospect of doubling the value of the company from development drilling alone with potential incremental value from its exploration prospects. *Vulcan Minerals* (bought as fully-deductible flow-through shares for certain taxable Canadian accounts) is exploring for oil onshore Newfoundland with potential for a 50 million barrel find. *Canadian Superior* produces 2,700 bbls/day in Western Canada which with anticipated development in Alberta supports the current stock price. But we believe we're getting free the massive offshore Nova Scotia gas exploration potential where the company's 1.3 million acres makes it the third largest landholder. Successful drilling in this region could triple the value of the company, with the company's Trinidad concessions potentially contributing to an even larger payoff.

These companies are virtually debt free, trading at a discount, in some cases quite substantial, to our current appraised value and each has tremendous growth potential. These companies should do well over time even if oil prices were to fall back to where they were last year.

We own three small cap gold positions: *Etruscan* (West and South Africa), *High River Gold* (Russia and Burkina Faso) and *St Andrew Goldfields* (Timmins, Ontario, Alaska and British Columbia). Each of these companies should be low cost producers with fast growing production over the next 3 years. They all trade at substantial discounts to their current fair market values which will materially increase with production ramp ups. With *Etruscan*, we're also getting the company's highly prospective South African alluvial diamond play.

Specialty Foods is a US producer and marketer of premium (Nathan's Hot Dogs) and private label specialty meats (beef and pork). It is an income trust which has recently temporarily suspended its payouts from the short-term pressure of higher costs because beef exports have been curtailed since the Mad Cow scare caused prices for beef and pork to escalate. Though the company is passing its higher raw material costs on to its customers, there is a lag period and the company has been trying to catch up as costs have been continually increasing. The company is still profitable but ceased payouts to replenish the working capital used to fund higher payout levels in the recent past. By spring of next year, or sooner if beef/pork prices fall, we believe the company will return to normal profit margins. With falling raw material prices, the company could even enjoy a period of outsized profits. We believe the company could resume a payout of \$.60 per unit in the next 6 months for an annualized yield of 20% on its current \$3.00 price, with potential capital appreciation which could double the unit price.

In our RSP accounts we also hold *Northstar Aerospace* (helicopter gears, transmissions, etc.) and *Magnifoam Technology* (specialty silicone supplier) which are two Canadian manufacturers with a commanding presence in their respective niches. They both trade at single-digit P/E ratios and have excellent prospects for sales and earnings growth and for double-digit P/E ratios.

All these acorns have the potential to be mighty oaks. If the squirrels don't get them first. And they often do. When the markets decide to go down, the mid and small caps can go down more quickly from lack of liquidity. So owning this group, by definition, can mean more volatility, which is lovely going up, but to the uninitiated can be terrifying on the way down. That's when we need to be salesmen and psychologists. When clients need to be reassured: "This is a temporary setback, not permanent impairment." Sound familiar? We tend to take some of the sting out of the pain with shorts which, hopefully, will decline enough to offset the pain of our core smaller cap longs. The ability to hedge with shorts is definitely an edge. Nonetheless, investing with us means periodic "draw downs" (declines of some significance) and short periods of underperformance. But Buffett, Templeton, Tweedy Browne, Oakmark, Longleaf and other successful investors often underperform in the short term too.

Oaks Are Good Too

Which is not to say we shun the oaks if they're cheap enough. So we also own bigger caps *Nextel*, *Wellpoint*, *Gold Fields*, *Delta Petroleum*, *UTStarcom*, *SanDisk*, *Kingsway*, and *AJ Gallagher*.

Investing successfully in stocks of whatever market cap requires the right kind of market. Acorns need proper soil conditions to grow. We think the current market conditions are conducive to equity investing. First, based on estimated earnings and interest rates, the SVA™ work tells us the market is more than 30% undervalued. For Q3/04, 63% of companies are reporting positive earnings surprises and only 15% negative ones. Forward 12 month earnings estimates for the S&P continue to increase to as high as \$74 giving a P/E ratio of just 16.

Cash on the sidelines, earning next to nothing, is about \$4 trillion—a lot of fertilizer to make acorns grow in a hurry. Indeed, liquidity around the world is high. China and Japan lead the way printing local currencies with which to support the dollar. Interest rates are still benign, and at 2.7%, so is inflation, despite the dollar dropping and oil rising, predominantly because wages are not rising as fast as inflation. Wages, which are the largest component of production, grew only 2.4% over the past year, the lowest one-year pace on record.

While some economists are forecasting a slowdown from worldwide rising interest rates and the drag of higher oil prices, there is contrary evidence that the economy continues to be robust. The recent Chicago Purchasing Managers Survey had new orders at their strongest reading in 20 years and production numbers the strongest since the 1950s. While Q3 GDP at 3.7% was slightly below expectations, it was nonetheless respectable, particularly given the drag of the higher trade deficit. The declining dollar will inevitably cause the trade deficit to improve and give GDP a lift.

Continuing low mortgage rates spur sales of new homes which rose 3.5% in September. In spite of concerns over oil prices, business spending has picked up and there has been an improvement in manufacturing activity. Consumer spending in Q3 rebounded 4.6% and inventories relative to sales were not excessive. Retail sales are growing and augur well for a respectable Christmas season especially as consumer sentiment is improving too. Of course, the frosting on the cake may be that unemployment may be set to improve if last week's better jobs numbers are a meaningful harbinger. The Fed just raised the Fed Funds rate to 2%, still historically low, and apparently with no impact on stocks. As import prices rise and employment improves, so will the general price level. But some inflation is okay for stocks which are, after all, a claim on hard assets too.

Now that the uncertainty of the Presidential election is over, the market has indeed celebrated their guy. The new administration intends to address the looming social security crisis with some privatization measures for younger contributors, intends to tackle runaway medicare costs and implement tort and tax code reforms. Changes usually happen in crisis, and these proposed changes on top of a lower dollar should make the US much more competitive and a more hospitable place for business investment. The government knows it needs to address the fiscal deficit through budget cuts and perhaps some innovative tax measures, such as a national consumption tax. Tax receipts are already improving from the recovering economy and have reduced the current budget estimates by \$100 billion. During the election, the President was between Iraq and a hard place, but now he can prosecute the war in Iraq without the same political repercussions. Resolving Iraq like Afghanistan should give US prestige a boost.

The declining dollar will allow US manufacturers/exporters to become more competitive and US multinationals more profitable. To the benefit of the safe dependables, such as Coca Cola, Pepsico, Pfizer, Kimberly-Clark, Procter & Gamble, Disney. And US manufacturers/exporters, General Motors, Ford, IBM, Intel, Boeing, Reebok. And guess what? Because of all the problems in big company land, many have gotten downright cheap. The drugs have problems, but could be a contrarian's dream. Pfizer trades at only 11.7x earnings.

So, as always, we are looking at the big caps, which now seem to have greater attraction. They will be the main beneficiaries of the changes that are coming over the next few years. That's where the relative value may now reside. Remember too, they're the ones that pay the dividends that are taxed more generously.

Fickle you say. No, unabashed value opportunists.

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