

LOOKING FOR THE PONY

A good September quarter though October lived up to its well deserved reputation. Some recovery now, but tricky markets against a backdrop of lousy news. Rising interest rates. The 12th successive Fed funds rate increase to 4%. Maybe more to come. And a new Fed Chairman soon. Uncertainty. Rising inflation, mostly from higher energy and food prices. Good for oil stocks, bad for stocks generally. And then the inevitable correction in the price of oil. Bad for oil stocks, but some relief for stocks generally. The flat yield curve conundrum. Devastating hurricanes. Global warming. Avian flu. The war in Iraq. Unrest in France. Terrorist attacks in Jordan. Finance Minister Goodale's attack on Canadian income trusts. Justice Gomery's attack on the Liberal Party. Struggling US automakers. Delphi, the largest auto parts company, bankrupt. Record national debt and consumer debt. Credit derivatives up to \$12.4 trillion. Trillion! Hedge fund underperformance and the occasional scandal. Declining consumer confidence. Poor retail sales. Record trade deficit in October (\$66.1 billion). Yet a rising US dollar. Go figure. Slowing housing market. A bubble burst? Waning popularity of President Bush. A lame duck? Geopolitical risks from troublemakers North Korea, Iran and Syria. The first two of them with nuclear ambitions. Say uncle.

If not a minefield then definitely at least a pile of manure. Yet we think there's progress. Which brings us to our title. Being hopeful in the face of this litany of problems reminds us of the boy who upon entering a room full of manure remarked, "There must be a pony somewhere in here."

Shameless Opportunists

We're from the school that believes there's always a "bull market" somewhere. By that we mean there's always an opportunity to make money. We're always looking for the pony. That doesn't make us optimists necessarily, but it does make us unabashed opportunists. There are many kinds of investors. Cockeyed optimists for whom hope always springs eternal, hope being a dangerous feeling for investors. Eternal pessimists who believe the end is nigh—hyperinflationists; depressionary deflationists. Long-term investors who ride them up and ride them down. Still banking on getting back to \$100 Nortel. Traders who chase momentum and think they can walk on water after five successful trades only to drown in the sixth. Blindsided, à la Refco.

Then there's our kind. Value investors. Looking for what's cheap. Buy low, to minimize downside. And wait. Trading off risk for patience. Skeptics, because managements invariably put on a good front. Agnostics, because headlines exaggerate and economists use a rearview mirror to tell you the business condition. Contrarians, often, inclined to go against what's popular, but not always. Not always, because sometimes the consensus *is* right.

Opportunists prefer when the market is going up, but can take advantage of the downs, buying cheap stocks even cheaper and profiting from short selling. Like we profited from the bursting of the tech bubble in 2000.

Fact is, despite all the apparent dung we think there's a Shetland in there somewhere. Fact is, our mandate is to preserve client capital and get satisfactory positive returns. No matter the strength of the economy or geopolitical turmoil. Much can be lost in a strong economy if stocks are too high and interest rates are high and rising. Conversely, much can be made in a weak economy if stocks are low and interest rates are low and declining. Stock prices depend on: their current valuations; the direction of corporate earnings; the level of interest rates; liquidity, i.e., the availability of money to buy stocks and bonds; and the right investor psychology. In most regards, we think, currently, there is opportunity, though we need to be selective because the overall market could still correct.

Getting Lean and Mean

In our work, the market is currently over 30% undervalued. Corporate earnings have been rising rapidly. Over 70% of S&P 500 companies reported positive surprises in Q3. S&P 500 companies have had double-digit year-over-year growth for the past nine quarters. But there is potential for some slowdown in that pace from rising cost pressures. GDP growth in '06 could decline from 3.5% in '05 and earnings growth would decline too. Meanwhile, corporate America continues to get lean and mean. In the face of higher costs and, for exporting companies, a higher currency too, US companies are having to become more competitive and productive, and it shows. Productivity as measured by declining unit labour costs is improving. US real wages fell 2.4% last year and productivity is up 3%.

GM and Ford are closing plants to cut production capacity. GM intends to lay off 30,000 workers. That's over 6 times Google's entire work force. Ford will cut 4,000 jobs. Delphi, the largest auto parts supplier, in Chapter 11, wants to dump its underfunded pension liabilities on American taxpayers and cut its workers' wages and retirees' health and life insurance. Painful, but necessary in order to survive and compete. Sad to say, but Chapter 11 is becoming an acknowledged tool for bloated corporations to purge themselves of high labour costs, excess workers, wages, pension liabilities and health care costs in order to compete and thrive. The airlines have become masters at it. Others may soon follow.

Cavalry On The Way

The US government is pitching in too with tax reform measures, recommended by the President's tax committee, that benefit business, reducing tax rates, abolishing the Alternative Minimum Tax, encouraging more money to be put into businesses and less into houses as home mortgage interest would no longer be deductible (replaced with a 15% credit for mortgage interest for a principal home) and allowing businesses to expense capital purchases. Pro growth policies for sure. Equities should be the winner and the housing market the loser.

The American Jobs Creation Act is 2004 legislation that provides powerful tax incentives for US companies that repatriate their earnings from their overseas subsidiaries. Investing in America is being stressed.

With its high dollar and similar cost pressures, Canada will need to get more productive and implement some tax cuts too. It's happening.

We hope (and believe) the US dollar is just about through going up. The Euro and Yen are at multiyear lows. Toyota is gaining market share and has a market cap equal to GM, Ford and Chrysler combined. It's loving a low Yen. To offset sales, down 24% in October, and to get rid of excess inventories, GM is having a Red Tag sale. Imagine a Tag Day for GM. Meanwhile the Japanese economy is improving, reforms are being implemented, the many years of deflation appear ending and the Nikkei Dow is at a 4 year high. There's a good chance interest rates in Japan will soon have to start going up on their way to "normal" too. Whenever deflation gets to zero. Then the dollar will decline against the Yen and maybe a revitalized GM, Ford and Delphi can be resurrected. What's good for America is good for GM. Toyota beware.

Bottom line for us is cost reductions and a lower dollar should ultimately translate into better revenues and earnings. For multinationals, a lower dollar would also mean repatriating foreign earnings at better currency translations, contributing to better reported earnings. A pony.

Merger Mania

In the face of rising costs, competitors will merge and acquire. Rationalize. To reduce costs. To become more productive. To gain market share. Lower costs mean higher margins and higher bottom line profits—one ingredient of higher share prices. In the US, M&A activity totalled \$823 billion as at the end of Q3, already more than '03 and on track to beat '04.

In our view, there are too many airlines (most countries have one national carrier—and in Canada even it went bust) and too many automakers (making too many brands of autos, we think). Look for more mergers. Delta-United-American-Northwest Airlines Inc. General Ford. Why not? Who would have thunk Daimler Chrysler? The losers, temporarily, will be workers, as redundant jobs will be lost and wage growth restrained. Lessened competition means better corporate pricing power. The winners will be shareholders and ultimately the US economy.

Interest Rates Peaking

Another driver of share prices is the level of interest rates.

While interest rates are on the rise, they are still close to the lows of the 23 year bull market in bonds. And they're still at a level where they support consumer demand and business activity. The Fed raised rates to curb the excesses of rising asset prices, mainly housing, but stocks too, and they have clearly achieved some success. In the process, likely intentionally, the interest rate differential has supported the US dollar making imports cheaper and curbing inflation. Housing is clearly slowing and the consumer, who hasn't saved at all, may now be ready to put some away. Recent personal income and consumption figures support incipient growth in the savings rate. If consumers don't spend on consumption, their savings become firepower for stocks and bonds.

The risk is that the wealth effect from stagnant or declining house prices may constrain consumption too much and cause a slowdown. Remember, consumer spending accounts for 2/3 of GDP. The consumer's mortgage and credit card payments are rising too with higher mortgage interest and newly mandated higher credit card amortization. Not to mention the toll that higher energy prices are taking on the wherewithal to spend.

We're already seeing the effects of this on housebuilder stocks as they warn about their future prospects. Toll Brothers notes "some softening of demand in a number of markets". Fannie Mae, the largest US mortgage buyer, forecasts slow home sales and moderating price gains. US house affordability continues to fall. Many retailers are disappointing. Clothing retailer GAP said Q3 profit fell 20% as it faced its worst sales slump in more than three years. Wal-Mart reported its smallest quarterly profit growth since the '01 recession. It moved to cut prices and promises labour cost improvement in the next quarter. Target had a disappointing Q4 outlook and expects a fiercely competitive holiday season. Moreover, continuing auto incentives may steal some business from other retail.

In all, this suggests a slower economy. It should show up in future retail sales (ex autos, of course), GDP growth, layoffs, and, ultimately, in employment. The Fed tends to linger, but we are likely close to the end of rate hikes and if the slowdown is pronounced, and inflation behaved, we should see a reversal in Fed policy to easing again in early '06.

It would thus appear that consumer spending will slow and so will the growth of the already gargantuan consumer debt, something we've been concerned about. The other big debtor, the US government, at \$8 trillion of debt, will have to take steps to rein in spending too. Which it says it intends to. Because tax receipts have been higher, bolstered by higher personal income tax receipts and the one-shot tax on corporations repatriating foreign earnings, the White House expects the budget deficit for '05 to reduce to \$333 billion, a \$79 billion drop from last year. 2006 may be trickier.

Corporate balance sheets are in great shape as corporate cash flows have improved and corporations chastened by the bursting of the tech bubble have found some spending discipline. Indeed, corporate earnings yields are 2 percentage points higher than corporate bond yields, encouraging buybacks and dividend payouts. And reinvestment. Borrowing costs have been below the earnings yield for the longest period in over 25 years. A pony. Actually, maybe 2 ponies.

A Lower Dollar

The wild card for us is the US dollar. If it tanks, as it could indeed, whenever foreign central bank holders of excess dollars (the Japanese, the Chinese, Middle Eastern oil exporters and the like) decide to diversify away from dollars, say, into gold (as is already the case for Venezuela, South Africa and Russia), then the dollar could fall, maybe precipitously. US interest rates would then need to stay high in order to make US treasuries attractive and to keep resulting inflation at bay. But it is not in the interests of exporters to the US to cause such a decline and so they will likely be motivated to continue to support the dollar by recycling their export surpluses into US debt instruments. Moreover, if the US economy does slow, its trade and current account deficits should moderate from declining imports. And if the US economy slows, so will the rest of the world. Then real interest rates everywhere should stay low allowing continuing support for the US dollar. But we're nonetheless watching carefully.

On the other hand, a gradual decline in the dollar, which we expect, will be helpful to the US economy and corporate earnings, especially if inflation remains constrained.

No Shortage of Money

The third element for better markets is liquidity. Well, even as the Fed has been raising rates, it's been keeping the availability of money adequate. Investors have lots of money tucked away in money market funds and other cash type deposits to fund future stock and bond purchases. Strong corporate balance sheets and corporate reluctance to spend capital have incited corporations to pay out hefty dividends, to buy back their shares, and to acquire other corporations for cash, in each case putting more cash in the hands of investors for reinvestment. Private firms have been heavily engaged in buyouts too, such as Koch Industries buyout of Georgia Pacific, the world's largest tissue maker.

GM, in restructuring mode, still pays a hefty 8% dividend. Which the elderly, like Kirk Kerkorian, depend on to pay the rent. Tax incited repatriation of corporate earnings to reinvest in the US has enhanced liquidity. And, again, as more money is saved and not spent and money is diverted from housing, liquidity for financial assets is enhanced.

Investors Cautious

Which brings us to psychology. Market watchers are a perverse bunch. The worse things appear, the greater the degree of pessimism, the better we like it. We even have tools to measure investor sentiment. Oscillators, volatility indexes, put-call ratios, new highs to lows and the like. And based on those, the market is, short term, overbought. The DJIA, in our SVA™ work, is still "on sell". Maybe 10% more on the downside. But the NASDAQ, with most of its technology stocks having already completed their own multiyear bear market, is looking like it has based. There's always a bull market somewhere. We wouldn't own Google because, as value investors, it's just not what we do, but we note that Google has more than quadrupled over the last year since coming public. Microsoft is exciting investors with its new Xbox. The NASDAQ ponies are chomping at the bit.

On Golden Pony

Nothing to do with idolatry, we have our golden pony. At \$490, gold is at a 17 year bull market high, and the XAU index of gold shares has reached an 8 year high. Indeed, other than the grains, most commodities are running. Copper is at a record high. Platinum, a 25 year high and palladium is starting to go too. Zinc is at an 8 year high and aluminum at a 10 year high. The CRB commodity index itself is near record highs.

Gold, which normally moves opposite to the US dollar, has been soaring even as the dollar rose, making a 17 year high in Euros and a 14 year high in Yen. The world is awash in liquidity and there are inflationary pressures, good for stocks, but especially for gold and gold stocks. Whenever the dollar resumes its decline, gold could go much higher.

While the larger cap gold stocks have mostly benefited, the market will soon recognize the mid and smaller cap gold stocks as buyers move from Clydesdales to ponies.

Indeed while gold stocks are rarely cheap, usually trading at premiums to net asset value and relatively high multiples of earnings and cash flow, the ponies offer much better value. As value investors, our stable of golden ponies do trade at discounts to their net asset values and are cheap relative to near term prospective earnings and cash flow.

Our key gold holdings have marked production growth lying just ahead. *High River, Etruscan, Yamana* and *St Andrew* are all set to more than double their production in the next two years. Each trades below net asset value, is cheap on estimated earnings over the next couple of years and generally has low operating costs.

Our mid cap precious metal stocks include Iamgold, Cambior, and PanAmerican Silver and, though not as cheap, should all participate in the gold bull.

Crude Ponies

We continue to overweight oils. The price of crude has had a material correction from \$70 per barrel to \$56. But the powerful underlying fundamentals from the growing demand that should overwhelm supply are still extant. Recent comments indicate that OPEC would likely cut production if crude prices approach \$50 per barrel. A fail safe. The onset of colder weather, after the recent unusually warm weather, is coinciding with the touching of key price support levels for oil and gas and, in our view, should cause a trend reversal back to the upside. With it will come a meaningful reversal in the share prices as sentiment changes. The companies we hold have growing reserves and production, excellent balance sheets and cheap valuations. While the oil stocks, big and small, have sold off from their highs and some of our bargain holdings have not been spared, they are now even better values. And they don't necessarily depend on higher oil and gas prices for us to profit. Their organic production growth will cause their share prices, over time, to rise at current, or even somewhat lower, commodity prices. The mere passage of time. Trading off risk for patience. Ponies all.

Pan-Ocean is our largest holding because of its low risk/high reward characteristics. Notwithstanding that it's down 40% from its all-time high in August, the company's outlook has never been better. It just reported Q3 record production and earnings, and, is set to deliver over 24,000 bpd of production by the end of next year, up from 10,500 bpd currently. Applying that higher production rate, at \$53 oil, the company currently is trading at only 4x end of '06 annualized earnings. In contrast, its peers trade for more than 20x this year's earnings and 13x next year's. Pan-Ocean trades for less than its independent consulting engineer's appraisal of net asset value of \$26, using only a flat \$42 oil price. And with an anticipated tripling in production from low risk development drilling, substantial exploration prospects to enhance value, low finding costs and almost US\$40m in working capital net of all debt to make it happen, it represents unusually good value.

The only three analysts who cover the company have \$50, \$50 and \$60 one-year targets. Pony, pony, pony.

Connacher's oil sands properties are superb. Bitumen will start to be extracted using conventional horizontal drilling at the end of '06. Capital costs should come in well below that of others in the region and the reserve life of its Pod 1 is in excess of 25 years. Pod 1 alone, which covers 2,000 acres, is essentially worth the entire share price whereas the company believes at least four additional pods exist on its other 65,000 acres. Drilling over the next few months should add substantial reserves. The stock trades at a 30% discount to its net asset value yet only one brokerage analyst follows this company.

Connacher recently spun out most of its Latin American subsidiary, *Petrolifera*, and we took up a small position. *Petrolifera* trades below the value of its net cash and Argentinian oil development assets alone, giving us free the prospective 5 million acres of property it holds in Peru.

At *Corridor*, the upper zone of its McCully field in south central New Brunswick is estimated to potentially contain one trillion cubic feet of natural gas-in-place. And, the Dawson Settlement zone, a much deeper zone, could contain up to 5 TCF of gas, not to mention the potential from land in PEI, offshore Cape Breton and offshore Quebec. The company currently has two producing wells in the McCully field and is drilling its twelfth McCully well with all previous eleven having encountered gas. Once additional reserves are established, a 30-mile pipeline will be commissioned to connect *Corridor's* gas to the Maritimes and Northeast Pipeline to New England, hopefully by the end of '06. We estimate the present value of *Corridor's* gas from the upper zone to be at least \$6 per share, 3x more than the current share price. The company's consulting engineer's reserve-based net asset value is 75% higher than its share price. *Corridor* trades at an estimated 6x '07 eps and less than 3x expected '08 eps and is followed by only one analyst. Pony.

Rally, *Delta*, *Kodiak*, *Canadian Superior*, *Sterling* and *Canoro* are all also cheap, trading at or below net asset values. Each has the ability to grow net asset values, cash flows and earnings from their existing asset bases. *Rally* is growing rapidly in heavy oil in Egypt, oil in Western Canada and is a partner in a major gas find in Pakistan. *Delta* is growing its US rocky mountain region natural gas production very quickly and has material upside from its land holdings in the Columbia River basin in Washington. *Kodiak* has made several key finds in Wyoming and has increased its value dramatically. *Canadian Superior* has grown its Western Canadian assets, continues to pursue its offshore Nova Scotian assets where the company is one of the largest landholders and, early in 2006, intends to drill a massive potential 4 TCF prospect offshore Trinidad. *Sterling* should add enormous value in the next few months from its activities in the UK North Sea and Romania. And, *Canoro*, trading well below fair value, has been our most volatile holding, but just redrilled two older wells validating its Indian-based Amguri field.

Other than *Delta*, which is covered by a half-dozen analysts, all our juniors have merely one or two analysts covering them. Hidden ponies. Clearly, as these companies add value and grow, analytical coverage will increase and the prices should rise to reflect fair value.

Bottom Up

Time and again we have written that, while there's opportunity in asset allocation among stocks, bonds, cash and short sales, and also among different groups, such as the oils and the golds that we now favour, in the end, the ultimate pony is good, old-fashioned, bottom up stock picking. In fact, even in our favoured groups, in the main we don't buy any old oil or gold stock. We want to own those that are undervalued, with growing reserves, growing earnings and growing free cash flow,

below their NAVs, with sound balance sheets and good managements. A piece of a good business. Oh, its price might temporarily fluctuate southward in an overall decline, which might make it even cheaper, and allow us to accumulate even more. But, in the end, when markets revert to normal, as they invariably do, our businesses should be properly valued to reflect their superior prospects. We'll have been well rewarded for merely waiting. By the market's reappraisal or perhaps by a takeout of our cheap businesses by other entities at a proper price. We may be older then, but our pony will be friskier and raring to run.

It's obvious we don't invest in a vacuum. We need to pay attention to the big picture too. And to our SVA™ work, as it concerns the big picture, which tells us when to buy and when to sell. Timing. There is much more we can know with certainty and with a greater ability to predict outcomes in the case of individual businesses than in the case of economies and geopolitics and markets as a whole. But if we think there's a slowdown coming, we gravitate to those businesses that we think will be less impacted. Safe dependables. Drugs. *TJX* because it's at the low end, a discounter, and should get even more closeout merchandise for resale. *Ruby Tuesday*, because it's an affordable eatery, and because a guy's got to eat. *La Senza*, because it sells affordable undergarments which a gal's got to regularly buy. Naturally, our work also tells us when to buy those individual stocks too.

We think we've got a great herd of ponies in our stable. And that they'll grow in time.

Some of our companies are recovering after clouds which obscured their value have lifted. *Kingsway* is well beyond its temporary losses in Ontario and Florida, yet the stock still trades at 6x expected eps, well below peers, even though it operates niche insurance lines with an excellent record of profitability. *LaSenza* has cut its losses from its Wet Seal stake, an unsuccessful foray into the US, and from the poor performance of its *LaSenza Girl* chain. This has allowed the superior performance from its core *LaSenza* lingerie chain to emerge. Still, the company trades for only 8x estimated earnings ex the net cash on its balance sheet. *CryptoLogic* trades at only 9x expected earnings, ex its \$5 of net working capital per share, even though its business is delivering consistent on-line casino growth and hyper-growth from the poker craze. *Ruby Tuesday* and *TJX Companies* are two newer additions that fell too far from intrinsic value based on, what we believe to be, temporary slowdowns in sales growth. Both companies have historically been very consistent growers but were trading at multiyear undervaluations recently. *Pfizer* trades at a 10% free cash yield with \$5 billion of net cash and has likely discounted its immediate term problems.

Pfizer and *Cambior* are our only potential tax loss sale candidates even though they are cheap. We prefer to not sell others like *Goldfarb* that trades at half of its liquidation value which could be realized by mid-next year on the culmination of its outstanding lawsuit. Or *Canoro* that trades at less than 1/3 of fair value where we'd be unlikely to replace the position.

In Income We Trust

In light of the recent correction in income trusts, our income accounts have been behaving more like growth/equity accounts in a bear market. Some income trusts were due for a normal correction after their extended bull run, which was exacerbated by the general oil and gas correction on those kinds of trusts which happen to comprise almost 30% of all trusts. Also, since the government had suspended advance tax rulings for trusts, a cloud was put over the whole sector. But even if some tax adjustments were to apply, our holdings would still represent attractive value. So, we've added some beaten up trusts, and averaged down in certain holdings which have been unduly punished.

Specialty Foods has replenished its working capital from previous periods when it over distributed and as a result temporarily suspended distributions. The company has remained profitable, raised prices, added new products and grown volumes. It now plans on building a reserve for future payouts. We expect a payout resumption early in '06 and believe that, at current prices, the company's earnings could support a 20% yield or even higher.

Entertainment One has had a rough year. The company has a commanding 95% market share in Canada in CD and DVD distributions and owns Koch, a content provider. This year has been anomalous for the company because of dreadful releases by the studios and the bankruptcy of two customers and a competitor. The company lowered its stated distribution for '06 to \$.90 from \$1.30, but could pay out even more as its seasonally most busy fourth quarter figures become known. Even at the depressed \$.90 level, the yield is over 20%.

Because those two trusts are now so compelling, we've even been including them in our dedicated growth portfolios.

Other trusts we own in income accounts include: Lakeview REIT (small town niche hotels) which yields 13%; Huntingdon and Lanesborough REITs (industrial and multi-residential real estate, respectively) which yield 13% and 11%; SunGro (the largest North American peat moss producer and distributor) which yields 14%; Custom Direct (the US's second largest direct-to-consumer cheque provider) which yields 13%; Student Transportation (North America's 5th largest school busing company) which yields 10%; and NewAlta (a waste oil recycler) which yields 9%. We expect these trusts to increase their yields as their businesses grow. At current abnormally high yields, they could all withstand temporary hits to their businesses without impairing their permanent long-term yield potential.

The overall yield of about 11% on our income portfolios is now the highest we've ever experienced. Our income trust holdings are yielding about 12% and should appreciate over time from current depressed levels providing capital gain potential. The fixed income positions we hold also yield an exceptional 10%. With the expectation of capital gains too, since some of these fixed income positions trade at a discount to par and some are convertible with good potential for conversion into their underlying low priced shares.

Roundup (pony puns intended)

We are portfolio jockeys. Our clients pony up their hard earned savings and leave it to us. The buck stops with us. They bridle and often nag when we don't perform. But when we do, it's a whinny whinny situation for both. But, hay, for us, the secret to successful money management is to continue to upgrade, to make sure we're not saddled with losers, hoof them out, and in the mane trot out the winners for the ride. There may be neighsayers, but the tail we tell is that we strive for a low risk, satisfactory return, outcome. Whether the environment is stable or not. Horseshoes help too.

Herbert Abramson and
Randall Abramson, CFA
November 23, 2005