

## CAB DRIVERS, OLDSMOBILES AND A BOUNCE

How are we all enjoying the millennium so far? Economic growth is deteriorating seriously—the biggest drop in manufacturing activity in 9 years, the first three consecutive months of decline in industrial production since 1991 and a shocking decline in retail sales. Company after company, even in previously thought invincible techland, is warning of profit shortfalls—Hewlett-Packard, Nokia, Motorola, Lucent, Wal-Mart and a multiplicity of others. And now come the layoffs and downsizing. Aetna, Air Canada, Nortel, Moore Corp., Office Depot, Daimler-Chrysler and in the case of Montgomery Ward, the ultimate downsizing—bankruptcy. And, not surprisingly, the stock market has taken it on the chin. In 2000, the Dow Jones Industrial average fell 6%; the large cap S&P 500 index, 10%; the technology-laden Nasdaq composite index, a whopping 39%; the small companies' Russell 2000 index, 4%; and the TSE, which had been up 35%, ended up only 6%.

We weren't surprised by any of this. Our quarterly letters for more than a year have warned of the bear market and the potential for a slowing economy and some other ugly side effects we'll refer to below. The titles of our last four quarterly letters were: "The Bear is Stirring" (January), "Riding Out the Storm" (April), "Anatomy of the Bear" (July), "Goldilocks and the Bear" (October). And, by sticking to value and anticipating the decline, 2000 turned out to be a relatively good year for us and our clients.

We often ruminate on how we ever purport to predict such trends when to other smarter people than we, they are less obvious. We don't employ an economist because economists' views are generally based on historical data whereas the market, often being a good leading indicator, has already reacted by the time economic developments are known. We do however pay attention to the views of cab drivers, bellhops, retail salespersons and general advertising. They tell us the economy is a bummer as it hits. Honestly, today a cabdriver pointed out that the condo market is slowing. A sign on a Bay Street development several weeks ago said "only 12 units left", but today it said "only 22 units left". That's negative growth alright!

Because we've lived through several economic cycles we know that downturns are inevitable, indeed healthy, to work off the excesses of the upturns. In this case our foresight was made easier by the fact that the upturn was gargantuan, sometimes grotesque, could not continue indefinitely and had in it the seeds of its own destruction. Plain common sense told us that.

After all, half of US households owned stocks and increased their net worth by 50% in the last five years, driving the biggest market bubble ever. History shows that all bubbles burst and we surmised that as the bubble would be losing air, the consumer would naturally pull back. We also believed that the consumer was overextended with credit and sated with "stuff".

Where can you go when 85% of US households with a child and an income of at least \$70,000 already have a computer? Accordingly, we've just witnessed the first year-over-year decline in computer sales since the dawn of the computer age. The growth rate in cell phone penetration could be peaking too. And 750 of 1000 of the US population already own a car (it's only 10 of 1000 in China) and the average age of the fleet is pretty new. When the loss of wealth from its peak on the Nasdaq alone approached \$1 trillion, that's bound to affect the consumers' intent to spend on more "stuff" that they've already got enough of.

Business was overextended too with capital spending on a snort and corporate debt rising to dangerous levels. Just like the consumer, business was also becoming sated by "stuff"—too much capacity and too much inventory. Too much capacity contributed to the Asian debacle in 1998 and was a cause of the 1929 downturn. Today, for example, car dealers have too many days of inventory on their lots and worse, car manufacturers have too many manufacturing plants—GM alone, probably four too many and obviously too many Oldsmobiles, now discontinued. All this is a natural outcome of a protracted business cycle fed by a wealthy feeling, free spending consumer encouraged by the liberal monetary policies of central banks.

Irrational exuberance is finally getting a cold dose of reality, in a hurry. The tech market got destroyed and many dot-com companies with questionable business plans that never deserved the capital allocated to them may not survive 2001. We suspect this year will witness a record number of corporate bankruptcies and that generally, this will be a more ugly downturn than commonly believed.

But even though we believe that the markets will go a fair bit lower before the bear market finally ends, our work tells us that we likely reached a temporary bottom in late December and we could have a bear market "relief" rally that lasts several weeks, maybe even several months.

Thanks to newfound religion from the Fed, interest rates have started to decline and money supply will start to grow, to accommodate better equity prices and make "stuff" more affordable. Share prices have declined significantly which obviously makes many stocks much better values. It's still a minefield though as the economic downturn poses risk to all company earnings' streams and many stocks, particularly technology, are still too expensive and to be avoided: Cisco at 46x earnings, EMC 72x, Juniper 130x, Sun 44x, Siebel 112x. The Nasdaq 100 itself is still a lofty 55x earnings.

But psychology, one of the most important determinants of future share prices had become too bearish, driven by negative headlines and alarming forecasts, to the point where there was evidence of some selling exhaustion. We measure this with various sentiment indicators including the percentage of investors who are bullish relative to those bearish and whether corporate insiders are buying or selling. Many of these indicators were suggesting an "oversold" condition in late December when we turned bullish.

Anecdotally, too many stocks such as Intel, Motorola, Dell and Hewlett Packard have stopped declining on bad news, usually a sign that a market is washed out. Considerable cash from stock liquidation has moved into money market funds, ready to fuel the next rise.

Based on our work, the stock markets had hit certain support levels from where we expected a 10-20% rebound.

For those accounts where we were short stocks as a hedge, we have covered all of our shorts but two. For all growth accounts, we have initiated, trepidatiously, some new longs that we believe are inexpensive and can participate in a rally but not hurt us if the rally peters out quickly. Significant declines from their highs, low price/earnings' multiples and strong balance sheets are prerequisites. We repurchased old favourites Cryptologic (internet gaming); three retailers, InterTAN, Intimate Brands and Abercrombie & Fitch; and added new names, fallen technology stars Gateway (computers), Microsoft and Symantec (software).

The US retailers we recently purchased were all trading at prices which were less than one-half of our appraised values for these companies. Intimate Brands (Victoria's Secret and Bath & Body Works) and Abercrombie & Fitch have superb track records, phenomenal returns on capital, rock solid balance sheets, excellent square footage growth and exceptional product lines which should withstand a softening economy. Both companies reported disappointing Christmas sales, but their stock prices have risen nonetheless. They simply got too cheap. These are wonderful companies which we could own for years unless our negative outlook for the economy and its market implications in the latter part of 2001 get us out sooner.

InterTAN and Cryptologic are both names which were profitable for us in the past. Both are selling at very substantial discounts to their true values and each company could be acquired at valuations well in excess of current market prices. InterTAN is "RadioShack" in Canada and Australia. The company also has the rights for several European countries. RadioShack Corporation itself is a public company in the US which trades at three times the earnings' multiple of InterTAN. The US company has shed all of its other businesses and its sole focus is its RadioShack franchise. We believe that the US company will want to expand internationally; therefore, it will have to go after InterTAN.

Cryptologic continues to make solid profits from internet gaming. It now has relationships with well established licensed gaming operators in the UK and Australia. Proposed US legislation to prohibit internet gambling keeps failing to make it through Congress. Cryptologic continues to have a major market share in its niche and there are too many large companies that are likely to covet its business. At \$16, the company trades at about 8x earnings with \$6 per share in cash and no debt. The combination of slower growth (self inflicted due to a product launch delay), higher costs (essentially one time in nature) and the dot-com debacle has allowed us to get back into this stock at a very cheap price.

As for our tech purchases, Gateway sells PCs and has been a solid performer for a number of years. Its earnings have come down recently, but the company still sells at less than fifty cents on the dollar of value. Microsoft has also disappointed as its growth rate has slowed. However, its legal issues appear to be discounted in the stock price and the latest operating system—Microsoft 2000—should provide the company with a needed boost. With over \$24 billion in cash, Microsoft may be in a fortuitous position to acquire other depressed tech stocks in the next year. The company very rarely trades below fair value and when we believed the stock bottomed, we initiated positions. Symantec sells software including seven of the top twenty business software programs, of which Norton Anti-Virus is number one. The company has been a great grower and also has a super balance sheet.

We continue to hold healthy positions in other very cheap companies like Hurricane Hydrocarbons, PanAfrican Energy, Canadian Natural Resources and Franco Nevada. While these stocks may not participate in this market rally, each has exceptional upside, solid fundamentals and years of growth ahead. We expect to be well rewarded for our patience. By way of example, Hurricane is trading at

\$7.40 or 2x earnings. If the company paid out all its earnings in the form of a dividend, we would have a yield of around 50%. Contrast this to the market multiple of 26x earnings. Hurricane will grow its net worth in 2001 by 80% and it has essentially paid off all its debt. The returns it generates from finding oil are impressive. Finding costs are less than \$2 per barrel compared with average finding costs of \$8-10 in Canada. Ultimately, the market will be forced to recognize this great value.

We are also looking to add to our oil and gas stocks because we think oil and gas prices will likely stay high and future cash flow and earnings of producers will be spectacular. The stocks remain cheap in the belief that oil and gas prices will decline in the slowdown. We, however, believe that the supply will continue to be inadequate. We also note that a major consolidation phase is underway in the oil patch and hope to buy a company that can be acquired.

While we sold Agnico Eagle because of its relative leverage, our work tells us that golds are historically cheap and we intend to keep a good weighting in that group. Once again, psychology after a 20-year bear market in gold and silver is so bleak that any unforeseen circumstance could cause them to surprise dramatically on the upside. When the bear market resumes, this group should act as a hedge.

One of our favourite US gurus, Don Hays, believed as we did that a rally was imminent, but is also forecasting a deflationary period ahead. We, however, think an inflationary outcome may be a possibility. Recessionary and inflationary like the 1970s after the oil crisis of 1973. Stagflation.

Inflation is a monetary phenomenon. The more money is printed the more it depreciates against hard assets, and as the Fed jacks up money supply to counteract the economic slowdown and market debacle, the excess money should stoke the fires of inflation. High oil and gas prices on one hand are recessionary in that they act like a tax on consumers and leave less money available for other "stuff", but at the same time increase prices not only at the gas pump and for home heating bills but for airline tickets and all things made from oil and gas. Higher electricity prices in California will surely raise costs and prices in SiliconValley.

Capital was for some time misallocated to highflying dot-coms instead of basic manufacturing and resources, so look for some scarcities to potentially develop even as the economy slows. Many fertilizer and metal producers are selling their gas and electricity rather than produce their product. The Commodity Research Bureau Index of commodity prices is rising. Labour remains tight and as costs rise, workers will demand higher wages to offset them. Especially in California.

The US dollar looks to have peaked against most other currencies (maybe even the Canadian dollar) and a declining US dollar means import prices are automatically higher. President-elect Bush will push for his promised \$1.3 trillion tax cut, maybe needed more than ever for the slowing economy, but which will ultimately create additional stimulus to drive prices higher. So will the additional military spending he proposes. Necessary infrastructure spending, especially for power plants and improved grids, will add pressure. All in all, too, we think government surpluses have peaked. Budgetary deficits are probably inflationary.

In the end, the Fed may be in a "trap". Forced to lower rates and print money to forestall a recession (or get us out of one) even as the currency weakens and inflation threatens. Stagflation. That's probably not a time to own long-term bonds, but it should be okay over time for many kinds of equities.

So we've invested some of the cash we've been holding to take advantage of a market rally, but we'll try not to overstay our welcome. After the oversold condition of the market is relieved, stockholders are feeling more relaxed and their cash has again been run down, we believe the market will turn to the last "Capitulation" phase. The final new lows will be made in a scary atmosphere where panicked investors will be throwing in the towel. Maybe by next fall. The headlines then will be full of the weak economy, corporate and sovereign defaults, rising unemployment, maybe even international crises to test the new US administration. And Fed Chairman Greenspan may not look so omnipotent. But when it appears the bleakest, when as they say, "the blood is flowing in the streets", that's when we'll be seeing the really great bargains. Great companies at cheap prices. Great longer-term investments for the next inevitable bull market and economic upturn. In the meantime, capital preservation is paramount.

Randall Abramson, CFA

January 19, 2001