

## WINNERS AND LOSERS

### **Near Term Outlook Bleak**

The saga continues. A sluggish world economy. Its engine, the US economy, sputters. A mere 0.7% real GDP growth in Q4'02. 2.5% expected in Q1'03, but we wouldn't bet on it. The consumer, on whom the economy depends for most of its growth, is overindebted and cautious. Consumer expectations, looking ahead 12 months, have fallen to 72.8 from 80.8. Unemployment is high and that's holding him back. High oil prices are detracting from his spending power. The uncertainties of a potential war with Iraq and the ongoing terrorist threat are spooking him. Corporate defaults are high and bankruptcies at record levels. Many airlines, telecommunication companies and power utilities are bust and major layoffs and downsizing are announced daily.

The news is bleak. Weak industrial production and manufacturing activity. A declining dollar. A record trade deficit. A Federal budget deficit north of \$300 billion. States and cities are running deficits too, over \$50 billion, and are having to cut services in education, law enforcement, health and other essential services. Retail is lousy. The worst Christmas in 30 years. Maybe there really is a Grinch. Frightened by layoffs, terrorism and war, the consumer's confidence is low. Understandably. The consumer has lost wealth in his stock account and if he himself didn't own stocks, his confidence is being affected by the losses of his neighbours who did. We're talking trillions.

2002 was the third successive down year, a rare occurrence. The last time was 1939-41. December was the worst December since 1931. Four successive years of decline hasn't happened since 1929-1932, but this year is already off to a bad start with a down January (3.5% for the Dow), a month regarded as a reliable precursor of the balance of the year.

Even those dependent on fixed income are getting poor returns. Income investors are suffering historically low interest rates with the prospect of capital loss from longer dated bonds if rates turn up. And, of course, foreign investors are getting slaughtered from the declining US dollar. A declining dollar, while of obvious benefit to export industries, may engender higher rates to defend it.

Higher rates are not good for stock valuations. Our colleague, Ross Healy, has postulated a concept he coined "harmonic convergence" to describe the current phenomenon, where, because recently interest rates and the direction of the market have been moving in the same direction, a rising stock market will generate higher interest rates to ultimately, inevitably, snuff out the rise. A perverse inversion. A proverbial Catch 22. And our own SVA work suggests that the stock market averages which may rally short term, based on temporary oversold psychological conditions could decline another 15-20%, taking out the previous lows. So it's possible the Dow may see a low of, say, 6200 before its next advance.

## **False Hope**

There are those who believe that the economy and stock markets are being restrained by the war factor and that after a brief war in March, both will turn up. Even Alan Greenspan moots this. We believe that one way or another Saddam's goose is cooked, but that's essentially discounted. After a brief victory celebration, the bear should resume because the real problems underlying the market are the ones identified above: a post bubble economy, excessive debt at every level, lack of capital spending, low savings, an overvalued dollar, trade and budget deficits, underfunded pension plans, lack of pricing power, unemployment, a credit crunch and bankruptcies. The net worth of Corporate America, flat for 3 years, is now eroding from write-offs and pension contributions. Corporate creditworthiness worsens and downgrades are heavy. The cure for all this is time; time for the remedial reactions referred to in our last quarterly letter, "Elementary Physics", to take effect.

False hope is being given by the pundits who subscribe to market folklore. Because we haven't had four successive down years in stocks since 1929-1932 the shamans say, after 3 down years, odds are 2003 should be up. But, then they say a down January forecasts a down 2003. They also say because the NFC won the Superbowl we should have an up 2003. And, buy on Rosh Hashana, sell on Yom Kippur. Unless the Rabbi is an AFC team fan. My personal favourite, sell in May and go away. This time it should have been, go away for about 4 years. Students of market history believe it repeats. We believe market history repeats less than fried foods. Principally because the learned behaviours of the past discount the same reaction to a similar future occurrence. We're coming off the biggest bubble of all time and predicted normal outcomes may not fit. This may require thinking "out of the box". It may require considering the possibility of abnormal outcomes. That's not to say human nature isn't immutable and that one can't anticipate how investors normally react, out of greed and fear. We're getting set soon for the ultimate investor emotion—giving up all hope. The best kind of bottom.

## **Real Hope**

Though the markets may be going lower in the near term, we think we're into the beginning of the end. Deflation fears are waning from the inflationary effects of the weak dollar. And from 7.5% annualized growth in broad money supply and comments by Fed Governors that they'll do whatever they must to increase the supply of money, including buying new treasuries, to avert the dreaded deflation. Rising commodity prices, the CRB at a recent high of 249, \$35 oil and \$360 gold are helping to dispel deflationary fears.

Though layoffs continue, the rate is declining. In fact, 143,000 new jobs were added last month and reported unemployment for January dropped to 5.7% from 6%. The savings rate (4.3% in Q4'02, the highest since 1998) is increasing as cautious consumers restrain spending. Credit card debt plunged \$8.4 billion in December, the largest decline since 1968. Savings and capital formation are necessary to propel any recovery. The trade deficit is temporarily being exacerbated by the declining dollar, which automatically makes the same number of imported units more expensive. But, the declining dollar will start a process which makes US exports more competitive and US imports, including those from Canada, less so. Good for American capital spending and employment. While current corporate earnings improvements are being driven by cost cutting, not volume growth or margin improvement, companies are getting leaner and meaner, so that whenever top lines do start to improve, look out for super earnings improvements. And, these will be on easy comparisons with depressed earnings of prior periods.

We're already starting to see previous basket cases like Amazon.com, through efficiencies of operation, demonstrating results that at least indicate they'll survive. And, surviving is what it's all about in a stagnant economy. The weak players will fail and the survivors will benefit, from increased market share and diminished competition. Whoever said the meek will inherit the earth was clearly not referring to the market economy. As for the beleaguered airlines, the meek will sure not inherit the skies. But, watch how taking excess capacity out of the meek airlines will ultimately improve loads, yields and bottom lines for the strong.

These processes take time. Time. Apparently, it heals all. Inventories too are being worked off and will stay low relative to sales. Whenever demand improves inventory rebuilding will need to kick in and so will capacity utilization (only 75.4% now), and then ultimately, renewed investment spending. Time. Ministering to this ailing economy is a Republican President and a Republican Congress. Just the right kind of pro business doctors and the right kind of medicine. Lower taxes, less bureaucracy, a stronger military and a temporary deficit. That's what we need. More final demand. That and lots of monetary stimulus. And tincture of time.

Corporate governance concerns are waning. Martha Stewart has even stopped baking the pound cake with the file in it. Time. And it looks like she's not going to serve any. Not cake. Time.

The war with Iraq will soon be over and off the headlines. Progress will be made in democratizing the Middle East. Tyrants everywhere are starting to read the travel section. Saudi Arabia is already talking about an elected assembly. Then the US can turn its attention to the Israeli/Palestinian conflict. Then a deal needs to be made with North Korea, a really scary threat, when the US can better focus. Time.

And, Bush ought to become more popular than ever. The market in the interim could make scary new lows. Beware the Ides of March. But maybe by May, hopefully, the markets should be rising again. Buy in May, stay and play. Time. And, in the meantime, trillions in cash are building relentlessly on the sidelines, waiting for a credible recovery. Money market funds as a percent of all mutual fund assets are a record 35.5%. It'll get redeployed when confidence returns. Time.

### **Valuation Springs Eternal**

In the longer term, hope is irrelevant, valuations are what matter. So, although one part of our SVA work tells us the market could go lower, inexorably drawn to lower support levels, the valuation aspects of the work tell us that, at current interest rates, the market is already at an extreme undervaluation, the lowest since WWII. If it declines another 15-20%, to that lower support level, it will be a spectacular buy. Only earnings collapses of a magnitude we can't imagine or much higher interest rates could impair those valuations. In the meantime, all things being equal, the risk is coming out of the market and the reward potential is increasing. Big time.

### **Winners and Losers**

So, the economy will continue to be moribund. Perhaps for a prolonged period. And the market may soon rally, maybe merely a war victory rally, but then it's likely going to new lows. In this crummy environment, what do we investors do to protect capital and get some returns?

We note many strategists are reducing their equity allocations and increasing their cash and bond allocations. That seems too simplistic for us. Even inefficient. Particularly when we have the tools to improve on that allocation, namely a value investing philosophy, our SVA work and plain common sense. And, we're not afraid to say, our contrarian nature.

What does that mean? First, as value investors we only buy what's a bargain. A real bargain is a company that's absolutely cheap, that's got earnings, free cash generation and is growing, or about to resume growth if it's had a temporary glitch. Most will have strong and improving balance sheets. These may be small cap companies, like Pan-Ocean, CryptoLogic and La Senza. Mid caps, like Hurricane Hydrocarbons, CAE and Checkpoint or large caps, like Nextel, Laboratory Corp. of America, Concord EFS and A.J. Gallagher. These should be winners in any market. We look for common sense themes. Common sense tells us to play desirable themes and avoid the undesirable ones. The winners, not the losers. Oils and golds have been winners. We have a good weighting in each group. Airlines and technology are losers. We avoid those mostly; in fact, we're short AMR and Boeing and made a nice pass shorting UAL. Movies and entertainment are good and we're looking at this space. Consumers are sated with easily financed autos and struggling automakers are overleveraged and have outsized underfunded pension liabilities. So, autos are losers. Ford looks like it could go the way of the Edsel.

What we don't buy are yesterday's fallen angels—Nortel, Lucent, JDS Uniphase, and the like. Sure they may come back, maybe huge, but sometimes fallen angels never fly again. Remember Polaroid, Memorex and Burroughs. That's not investing, that's speculating. Sometimes it's gambling. Greed is for losers. We are investors who want assured steady returns from assured survivors. Winners. Sometimes, being human, we stray, as in Mosaic, Gemstar and AES, but we assure you we learn from the unnerving experience so we're getting even more disciplined to avoid potential losers no matter the potential upside.

We like stocks that are "non market" stocks, that don't really depend on the direction of the overall market to be winners. In this category are Newalta, Pan-Ocean and especially SMK Speedy and its parent Goldfarb which are in the process of winding up, we believe, with a reasonable profit to us.

In income accounts, we own high yielding income trusts but only those that either don't deplete their assets at all (A&W, Boston Pizza, Calpine Fund), or not too fast (Acclaim Energy and Provident Energy Trust). At least half of the accounts are in high yielding corporate bonds including some convertibles and preferred issues (Kinross, Nextel, Western Financial and Inmet bonds, and Pan-Ocean preferreds).

As contrarians, we avoid government bonds, especially longer term ones, because rising deficits, a weak dollar, rising commodity prices and the potential for more inflation are bad news for bonds. And at historic lows, where can interest rates go anyway? In fact, we think the 20-year bull market in bonds is today's bubble, that it's about over and that those strategists who think they're being defensive allocating to them are taking excessive risk for too small reward. Potential losers.

Conversely, we think the 20-year bear market in commodities, including gold, has ended and that a multi-year bull market in these is in progress. As contrarians we were early on gold and on the overvalued dollar, but being right makes up for being early. We're looking for quality commodity producers, miners, fertilizer companies, oil and gas producers. Winners.

We think the decline of the dollar is in earnest and could turn into a rout. Not generally good for US equities and bonds but beneficial for multinationals that repatriate foreign earnings at better exchange rates. Winners should be the drugs: Novartis, Merck; healthcare companies: Wellpoint, Tenet; consumer dependables: Kimberly-Clark, Pepsi, Coke and Wendy's; and entertainment giants like Disney and Liberty Media.

We believe the Japanese stock market is bottoming and there must be bargains there after over a decade of going down and several recessions. China and other places in Asia are of interest too. We'll look for some quality names or funds. We want winners.

There's always a bull market somewhere. We constantly look for what's going up, wherever. We want winners.

We pity our colleagues who run specialty funds because their specialized mandate can restrict them to losers with no other choice. The world is our oyster. Moreover, for those who allow us to sell short, to hedge their longs and reduce risk, we actually can often make money while the market's going down. The same common sense judgement that tells us what to avoid tells us we can profit by selling potential losers short. Like Four Seasons Hotels because the stock is expensive and the hotel business is lousy. Or AMR because it could go broke. Novellus, because it's unprofitable and very overvalued.

In 2002, our long/short accounts performed twice as well as our long only accounts. And we were never more than 25% short (we do reduce the short weighting to, say, 5% when we think the markets are at bottoms). Most of our taxable equity accounts are long/short and we urge all our taxable long only accounts to consider switching to this strategy. It works. We know how to use it effectively. We rarely use leverage. We diversify. And, we hope we're getting better at cutting losses quickly. We were up in each of the last 3 years while the markets declined. We were up in December and January even as the markets tanked. We're not stretching to outperform. We aim to preserve capital and get a reasonable return. If outperformance is a consequence, we'll take it.

We need to be disciplined, to choose odds-on winners and avoid losers. Themes, countries, groups and individual stocks and income securities. Sensibly. Carefully. Cutting losses quickly where we're wrong. Trading them out when they've hit targets.

Upgrading the quality of the companies at the bottom when the great companies get really cheap and there is a rare opportunity to own the best potential winners in the world. In the words of our own senior analyst, Darren McKiernan, "a chance to goldplate the portfolio".

Our proprietary SVA work gives us an edge. We think we have the experienced team to tough out tough times. Seasoned market veterans. Guys with corporate finance and arbitrage backgrounds. First rate analysts and traders. And, we think we have a good handle on the universe. Just pick the winners and avoid the losers. It's not so complicated and if we do it right, we'll be winners all.

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