

MAYA'S TAKE

We take the responsibility for looking after other people's money very seriously. Preserving their hard earned capital is paramount and achieving an above average return for them is our bogey. And, of course, if we succeed for our clients, it follows that we will succeed for ourselves, in growing our assets under administration and earning larger fees for our efforts. Nonetheless, we confess, that while all that is so, for us and many other market operators, being right is the real underlying satisfaction.

Absolute Returns

We could invest for returns merely in line with the market, like those index following managers who now need to buy more Nortel only because its proportion of the TSX has risen to 5% from its 2003 low of ½% (down from its 2000 high of over 30%). Regardless of value, or lack thereof. So as to perform "relatively" in line with the index. So as not to get fired. So as to gather lots of assets. And keep them just by performing a little better than the index. If it's down, just lose a little less. Let's play Mediocrity.

At Strategic, our objective is not to make relative, but to make "absolute", or positive returns for our clients, regardless of the direction of the market. In a risk averse way. With reasoned diversification. Without undue leverage. Or undue speculative positions. Thoughtfully. Patiently.

Playing the Game

Investing is part science, part art—but, very much, a game. Actually, several different games. Which need to be mastered. Process.

Saying what we do is a game does not denigrate the exercise or make it frivolous. It intellectualizes it. Game Theory is a respectable aspect of economics. MIT economist, John Nash, central character of the movie, "A Beautiful Mind", won a Nobel Prize for it.

Recently, for her school project, Randall's four year old, Maya, had to describe what Mommy and Daddy do professionally and what tools they use in their work. She said she only needed to interview Mom (a speech pathologist) because she already knew what Dad did. "What is that?" "He doubles people's money." She had once overheard Randall's explanation to her older sister, that his job was to make people's money grow. "You mean if I give you a penny, you can make it two?" "What tools does Dad use?" Maya was asked. "None", came the reply. "He just waits." This was alchemy. Right up there with Puff the Magic Dragon.

Buy and Wait

There's an element of truth in Maya's take. Our job is to grow client wealth. And that requires time. So we wait.

Doubling is good. Doubling over five to seven years is our bogey. But we also don't want to lose our starting penny. So, as value investors, we buy bargains—unpopular or little known companies. Mispriced merchandise trading below its intrinsic value because of some misperception or because it's below the radar screen. We buy bargains not so much because it allows a big potential upside, but because, if it's already low in price, there is not as much potential for downside. And, as Maya noted, we wait. Value investing requires patience because our unpopular merchandise has to be discovered by others, and that often takes time. We say we trade off risk for patience. Our anticipated holding period is usually at least three years. By then, Maya will be seven and a full-fledged analyst with us.

Fundamental Analysis

What Maya didn't understand is that Dad uses many tools in his business. Patience is merely one of them. But the starting penny, the business enterprise, has to be carefully analyzed. The real money is made in the buying, more than in the selling. We want to find good companies, better still, great companies, at good, or better still, great, prices. They need to have earnings, growing earnings, or the potential for growing earnings when they've temporarily faltered, like *CAE*. They need to have a strong market niche with barriers for competition to enter, like *CAE*. They need to have a strong balance sheet, like *La Senza* and *CryptoLogic*. And strong management, like *La Senza* and *CryptoLogic*. Where we can, we want to get to meet and assess management firsthand. That's important. It has been said there are no bad companies, just bad managements. And our stocks need to be cheap. Based on price to book value or net asset value. Based on price to earnings, to cash flow and, best of all, to free cash flow. Relative to prevailing and anticipated interest rates and to historical norms. Not to any current inflated comparable multiples. So, fundamental analysis is our first tool.

Finding Ideas

And we need to have tools to find ideas.

So the first game we play is Treasure Hunt. Maya relates to this. Hide and Seek for good ideas. Undiscovered. Lesser known. Misunderstood. In the case of shorts, overly popular, overly priced, sometimes to perfection, waiting for an inevitable misstep. Hunting for treasures really means being open to finding them. From wherever. A kind of osmosis. Screening for values based on our criteria. From good street research, of which we get tons daily. Helped by several services: one which tells us which analysts have the best track records for stock picking; another which does forensic accounting and highlights deteriorating fundamentals; and, one which points out which companies are subject to unusual insider selling, or better still, unusual insider buying.

We have our coterie of favourite Wall Street and Bay Street analysts who supply us ideas, on oils, golds, industrials, retail, fixed income, and so forth.

How do we presume to recognize the treasures in this hunt when so many others are searching for the same? There's the art in the game. Like beauty, value is in the eye of the beholder. Interestingly, our first block of La Senza was bought from another value manager. He clearly prefers brunettes.

Sometimes stock ideas are easy to find, but hard to lose. Good money managers should have the strength of their convictions, accompanied by a high degree of skepticism and a low degree of ego. They need to be prepared to admit mistakes and correct them quickly. This is a business of being a little more right than wrong, and cutting the losses before they sink you. Oh, and yes, you can love Maya, and loveable she is, but never fall in love with a stock.

SVA™ Work

Another important tool is our exclusively licensed SVA™ (Structural Valuation Analysis) work, which confirms our valuations, and times our buys (at support levels), and our sells (at resistance levels), an important edge we have over other value investors who may only know it's cheap. The "whether to", but not the "when to". We've learned to listen to the work more to avoid mistakes.

Each day, we update the universe we follow (currently, over 600 US and Canadian companies) with current balance sheet inputs and their lower and upper "breakpoints" (lower support and upper resistance levels) relative to their current prices. And each major index and sector too, based on the combined balance sheets of all the companies comprising them. Derived from this computer analysis is a computerized opinion based on our criteria as to whether each stock or index/sector is a buy, sell or short (in our work, the category "hold" does not exist). Maya would like this. It's sort of paint by numbers. So, recently, for example, it suggested to us that the XAU gold index and many gold stocks were going to inflect, or correct, downward, and accordingly, we propitiously lightened up on the group. When the golds hit lower breakpoints, we began repurchasing.

We also look at technical analysis, relative strength and stochastics, to suggest whether stocks are overbought and likely to correct, or oversold and likely to rally.

The Big Picture

A third tool is general market and macroeconomic analysis. We use many services to advise us: Don Hays, 13D Research, Tom Peterson of Bulls Eye Research, and others. Our SVA™ work also capably suggests the general direction of the overall market. This is important. In the short term, the direction of the market itself is the greatest determinant to the direction of the price of a stock. In a bear market, most stocks go down. When there are no good bids because fear and redemptions are forcing many to bail out, there's a good chance your cheap stock will get cheaper. Conversely, a rising tide lifts all ships, as they say, so in 2003, 85% of TSX stocks were up, a prescription for successful investing even if you were from the dart throwing school of stock picking.

Asset Allocation

We also need to make important decisions on asset allocation. Clearly, in 1982, when 20-year risk free Canada bonds yielded 18%, all of one's money could have been in bonds. What else could compete or work? Today, with interest rates at 45-year lows and liquidity so high, fixed income returns can't compete with potential stock or real asset returns, especially after taxes, (because capital gains are taxed more favourably than income returns). But then our economic analysis needs also to anticipate any changes in the economy, inflation and interest rates. When interest rates peaked in '82, as one could imagine, stocks bottomed (Dow 800), but as rates predictably declined with the rate of inflation, stocks boomed.

With the ongoing worldwide reflation, interest rates have the potential to rise and snuff out further stock gains. There is some debate whether general inflation, à la the CPI, will pick up, as have commodity and real asset prices, from the liquidity and continuing US dollar depreciation. Or, whether we are in for a supercyclical, deflationary slowdown where price increases can't be passed on, margins are squeezed, where excessive consumer indebtedness impedes final demand, where money supply implodes and unemployment rises. Some choice.

But it's most important for our outlook for financial assets whether interest rates will stay low or rise. Bond prices obviously depend on that. But equity prices are determined by earnings, the growth thereof, and also by interest rate levels and the supply of money. In the last several years, most stock market growth came from higher valuations derived from lower interest rates, not from higher earnings. Earnings themselves have also depended on low rates which allowed zero cost auto financing, low mortgage rates for housing affordability, a huge amount of mortgage REFIs to support consumer spending, and manageable debt service costs for the outsized amount of government, corporate and consumer debt, now at a record 350% of GDP. Moreover, low interest rates, relative to those of other countries, allowed the US dollar decline which, in turn, boosted revenues and earnings for many large US multinationals. In the last quarter, but for the decline of the dollar, IBM's 9% increase in revenues would have been only 1%. Clearly, then, any material rise in US interest rates from current anomalous multi-year lows would negatively impact the economy, corporate earnings and valuations. A potential mega whammy.

Poker

One of the games we play at Strategic is poker. Like everyone else, we see the up cards. They're a mixed bag. Very low interest rates, high stock prices, growing economy, slowing productivity gains, sluggish job growth, huge indebtedness, high trade and current account deficits, high budget deficits, a declining dollar, ongoing war and continuing terror threats, rising commodity prices, high oil prices and an uncertain presidential election year. Some good, some bad.

It's the down cards we need to guess. Like the prospect for rising interest rates. And whether stocks would become expensive relative to only moderately higher interest rates.

Given today's low interest rates and level of corporate earnings, they're not. Though, we think economic growth, without all the extraordinary fiscal and monetary stimulus seen in 2003, is likely to slow, so earnings growth should slow too. Especially since the pace of productivity gains must slow also.

But pockets of the market are extremely overvalued. Today there are 98 companies with market capitalizations over \$1 billion that trade over 10x sales (yes, sales, not earnings) compared to only 12 last summer. Not one market in the world, except Russia, trades at a P/E under 17. And John Templeton, renowned international investor, says he can't find any foreign market that's cheap.

In our work, the NASDAQ has just given us a Sell signal, and though the other averages remain on Buy, in recent times technology has lead the way. Margin debt is at its highest since the Bubble. Investor sentiment has been unusually bullish for a prolonged period and recently reached an extreme 81%, while bearish sentiment has stayed unusually low. Despite huge inflows, mutual fund cash as a percentage of fund assets is the lowest since early 2000. Remember that year. Some smart guys think we are in a new bull market, but overdue for a minor correction. Others think we are still in a primary bear market and all we've had is a 50% rally off the bottom, similar to the '30s or more recently in Japan. We're agnostics. All we want to do is not lose, and survive to play another day.

The Down Cards

Today, the down cards are especially difficult to predict. Down cards are not things that are necessarily unknown, because intensive research can sometimes ferret out some obscure fact. That's an edge for sure. But, more often, the down card does represent an unknown and, therefore, is only one's interpretation of what the outcome is likely to be, based on the up cards. This can be particularly effective when it's contrary to what is generally expected and, therefore, could give rise to a surprise. We can't know the future, but we can make a good guess about where investors have miscalculated the odds. If we're invested opposite to the crowd and a surprise happens in our favour, a great opportunity has been obtained, often with little risk. We love surprises in our favour. Maya loves surprises too.

Currently, the received wisdom is that interest rates will stay low and money growth high and that the Fed will be "patient" to change, that a continuing economic recovery is at hand, capital spending will ultimately kick in, as will job creation, inflation will stay subdued, corporate earnings will grow, stock prices will continue higher and house prices too. And that there is an afterlife.

But as you know from our previous quarterly letters, our take of what's in the down cards is somewhat different. Burdened by so much indebtedness, the US consumer who normally accounts for 2/3 of GDP is inhibited from further increasing his spending. His savings are nonexistent. His personal income growth is miniscule. And if he's unemployed, his benefits are about to run out. Imagine if interest rates rise and his debt service increases and/or his savings rate increases? Jobs are more difficult to create in this recovery because of the outsourcing of manufacturing, and even technology, to lower cost areas like China and India. The decline in the dollar can't come close to making US labour rates competitive with those countries.

Globalization is here to stay. The good part is that the consumer gets lower prices, manufacturers who invest abroad get lower costs and higher profits, and developing countries, like China, will enjoy an increasingly higher standard of living. Ultimately, we'll be the financiers; they'll be the manufacturers. And we'll all be consumers.

After years languishing, commodity and crude goods prices have taken off, to the benefit of their producers. But users, unfortunately, have been unable to pass those increased costs along to the consumer. Whether it's steel for autos or oil for airlines. A modest decline in demand could badly hurt these companies. Structurally high costs. Too much competition. A struggle to maintain market share and wait for the "good times" to return. So Toyota overtakes Ford as number two despite the lower dollar. Autos, airlines, telecoms, many manufacturers and retailers are reeling. Consolidations and bankruptcies will have to occur and are occurring. The weaker companies will have to disappear. Corporate Darwinism. Excessive debt will have to be extinguished. Maybe some pension obligations too.

Earnings might just be peaking and a slowdown may be in the cards (the down ones) after the November election, when governments and central bankers can finally get real. Bill Gross of Pimco, the biggest bond investor in the US, believes an economic slowdown/recession unseen since at least the early 1980s is going to happen. "High Noon", says he. Interest rates might stay low in that environment, unless a dollar crisis occurs if foreign central banks, such as those of China and Japan, stop buying US treasuries with the dollars earned from massive trade surpluses. That could cause a worldwide slowdown, China and Japan included. Fortunately, they know it too. Every country seems intent on destroying its own currency. One-downmanship. Some recovery.

Depending on policy responses and receptiveness of markets to policy responses, outcomes could be deflationary, or, very inflationary. Some choice. But it's okay if a down card merely suggests unpredictability. We can deal with that. Say, by holding gold, or cash. Until we get some inkling of what the down card might be.

Hold Them or Fold Them

In the meantime, when markets are as enthusiastic as they appear to be, driven by low interest rates and what could be false hope, we need to prepare for a negative surprise. Like any decent poker player, you have to know when to "hold 'em" or "fold 'em". And except for shortselling, bluffing doesn't work in this game. If we think the down cards are negative or maybe just unpredictable, fold them. Or make sure you have a winning hand, no matter the down cards. Folding them, for us, means, raising some cash or buying income securities, increasing the gold weightings (because they correlate negatively with stocks), increasing the shorts for our long/short accounts (currently up to 25%) and retreating to very cheap stocks or stocks less correlated to the market or to groups such as the oils and other commodity type stocks we think will withstand a market decline. Folding them means getting especially defensive. The overvalued shorts are the bluffers. See them twitch. We think they've got a lousy hand and we'll bet against them.

Upping the Ante

Another tool we use in our poker game deals with the quantum of our bets. Regularly, we run an ROR (Rate of Return) analysis which ranks our current holdings and stocks we currently follow, by their 3-year potential returns, based on forecast earnings and expected multiple revision. Just as in poker, the highest return stocks at the top are our royal flushes, followed by four of a kind, full house, and so on, as we move down the list to the mere pair of deuces. When the combination of our fundamental analysis, the SVA™ work and the ROR ranking deals us a royal flush, we raise, that is, we press the bet, and weight that stock in the portfolio much higher than for, say, a mere 2 pairs. Unlike men, all values are not created equal. A royal flush has to have a much larger upside, a lower downside and some sense of inevitability to its prospective outsized return. As Maya would say, a double, just by waiting. *Pan-Ocean* and *Petrokazakhstan* have been royal flushes. CAE, La Senza and *The Hockey Company* are excellent too, but only like three of a kind, so they warrant lower weightings.

We always, though sometimes reluctantly, seek to trim our biggest bets when they grow to become excessively weighted. It's prudence. Even if we think we have a royal flush, in this business, you sometimes find you're not playing with a full deck.

Puzzles

Portfolio composition is like putting together a puzzle. Maya likes puzzles too. We need all the pieces to come together to effect our desired outcome based on our opinions, without taking on undue risk. Not neutralized so as to merely break even—we're looking for risk adjusted, positive returns from our puzzle. But the right asset allocation, the right diversification, the right groups with the right correlations and the right weightings. Easier said than done. Our longs usually have much lower volatility than our high flying shorts. Try as we might, we still take some pain, as when "irrational exuberance" squeezes the shorts. But, from past experience, we know it's mostly short-term pain for long-term gain.

Musical Chairs

Usually when the shorts are winning, our game is conflicting with their game. Value Investors play "Buy Low, Sell High". But Momentum Investors play "Buy High, Sell Higher", also known as "Greater Fool", on account of you need one to buy from you. In poker parlance, if you don't know who the Greater Fool at the table is, you're him. This game works well in rising markets such as the kind we have currently. It's based on the theory that trends continue until they stop—that the "trend is your friend". The problem with this game is that all trends end, and near the end, the game morphs into another game, "Musical Chairs". When your good friend, the trend, ends—when the music stops, the Greater Fool finds himself without a chair. At Strategic, our chair is always lashed to our bottom, even though lugging it might make us get rich more slowly than our momentum investing playmates.

The Only Game in Town

Maya likes a variety of games. So do we. Portfolio management is about choice, about being able to construct portfolios reasonably, using a variety of securities to offset risk. But with interest rates so low and liquidity so high, yield starved investors are being driven, many inappropriately, into equities, often the wrong kind of equities. Equities have become the only game in town. By default. Someone has described today's investing public as having amnesia. As there being a "flight to crap". For some, who are risking their life savings, we fear that when the music stops, the game may be more like Russian Roulette than Musical Chairs.

As John Templeton recently warned, "This is a time to play safe." For us, it is always a time to play safe. To protect your capital from loss. Even Maya knows a penny saved is a penny earned.

Herbert Abramson and
Randall Abramson, CFA
Guest Contributor: Maya Abramson
February 12, 2004