

REALITY SHOW

The economy and markets are great levellers where dislocations and excesses are eventually purged. By facing reality. Like the reality TV show, Survivor, it's all about survival. About making sure you don't get thrown off the island. For us, as value money managers, we always need to measure reality against perception, recognizing that, in the short term, perception may be the vogue, resulting in temporary, ignominious "drawdowns" in our portfolio values, but that ultimately, reality will prevail and so will our clients. Short-term pain for long-term gain. Enduring a treat of live bugs for the big prize when we're the last left standing on the island. Survivors.

Value managers tend to eat lots of bugs, and often crow too, as they wait for reality to overcome perception. In the Bubble of 2000, a wacko island if there ever was one, as our momentum investing brethren embraced the perception that dot.com stocks would grow to the sky, we shorted many ridiculously overpriced stocks and, in the end, enjoyed a great year when reality kicked in and the Bubble burst. Wow, did Bubble Island become vacant fast, even though we had to swallow some awful live bugs along the way to survival.

Sometimes an investor's choice is not between reality and *perception*, but between reality and *deception*. As in the case of supposed "blue chips" Nortel, Enron and WorldCom. More like, casino chips.

US Survivor

World economies are being forced to confront reality. The biggest economy, the US, is weakening (3.1% GDP growth in Q4 '04), the current account deficit is too high (6% of GDP), the budget deficit is too high (4% of GDP), total US government debt of \$7.62 trillion as a percentage of GDP is too high, consumer debt is too high, consumption is too high (80% of GDP), the personal savings rate is too low (1% of disposable income), wage growth is anemic (+2.4% in Q4), the dollar is too high, interest rates are too low, social security is too critical, Medicare costs are too high, tort awards are too unrealistic, the tax code is too complicated and military interventions are too costly.

So a Fed on a mission, a Republican Congress and a tough quacking lame duck President are forced to ambitiously confront those stark realities with a view to survival. Short-term interest rates are being raised to discourage consumption and encourage savings. The dollar is surreptitiously being permitted to decline to discourage imports and encourage exports. A plan is promulgated to privatize social security for beneficiaries under 55, so they eventually get something at retirement. A promise to halve the budget deficit by 2009. To federalize class

action suits so plaintiffs can't choose states where juries offer the nuttiest awards. To gradually extricate the military from Iraq by training a local army and, one by one, eliminating other threats from Syria, Iran and North Korea. And from terrorism generally. To reduce geopolitical risk by encouraging conversion of despotism to democracy. As in Ukraine and Iraq. Iraqi terrorist leader, AlZarqawi, recently proclaimed, "Democracy is the enemy of Islam." Wrong! It's the enemy of Islamic terrorism. "Freedom" and "liberty" are the new buzzwords in Washington. "Family" and "faith" too. Monogamy is in and everyone's trying to get in on marriage. Idealistic values which, as value investors, we can also relate to. Survival in so many respects.

Foreign Survivor

The US has been the engine for world growth, with a huge appetite for imported consumer goods and an excessively high dollar that has benefited foreign exporters. No more free ride. Despite intermittent dollar rallies, like the one we've just experienced, the dollar needs to go lower to reduce the outsized US trade deficit. Foreign exporting companies from Europe, Asia, Canada, and almost everywhere else, are obviously suffering a drop in profit margins and their countries will endure an inevitable slowdown unless addressed with long overdue changes for survival. Growth in Europe is forecast at 1.9% in 2005—half that expected in the US. A Euro, which was 84 cents in June 2002 is now \$1.30. A Canadian loonie, which was 63 cents in June 2002, is now 81 cents. Those are painful increases for foreign exporters to absorb.

Europe needs to boost its productivity. So does Canada. Unemployment is likely to rise in both as manufacturers get more efficient. Germany just reported its highest unemployment rate in decades. Canadian unemployment is stuck at 7% and we lost 5,700 jobs in January. On the other hand, Germany also reported December factory orders of +7.1%, the largest monthly gain since 1991 and business confidence unexpectedly rose to an 11-month high in January, so some things may be finally improving. Europe also needs to reduce social welfare costs, government regulation and eliminate the 35-hour workweek and 4-week vacations. And reduce taxes. All these regions need to stimulate domestic consumption to allow growth and make themselves more self-reliant. German Chancellor Schroeder recently echoed a frustrated Italian Prime Minister Berlusconi's sentiment that their countries be allowed to have stimulative budget deficits in excess of the 3% of GDP limit mandated by the EU Constitution. They need growth. Survival requires change. Reality.

Interest rates are likely to remain dormant in the rest of the world even as the US raises its rates at a "measured" pace. But the US may be closer to an interest rate top than is generally perceived, particularly, as evidenced by recent lacklustre non-farm payrolls, because employment growth is tepid.

The Eurocurrency may stay strong on a secular basis as Foreign Central Banks diversify their growing foreign exchange holdings, now predominantly in dollars, to a more balanced portfolio including more Euros. And likely more gold too. The European Central Bank lost a billion Euros last year as a result of the weak dollar. Managers of Central Bank foreign exchange portfolios suffer drawdowns too.

The dollar should also decline further because the US wants it to, gradually of course, but sufficiently to make itself more competitive. As a result, their trading partners will need to make the adjustments to survive. Already, Democratic Senators Clinton and Dorgan plan to introduce legislation that would cap the trade deficit by requiring tariffs to be put in place if it exceeds that level. Rising protectionist sentiment should be an incentive for the dollar to drop.

While much of the world may be slow to embrace democracy, it is nevertheless on a fast track to embrace free market capitalism, even in authoritarian places like China.

Free markets beget growth and higher standards of living which beget middle classes which beget a desire for democratic expression which begets more international cooperation. So Ukraine has a free election and seeks to join the European Union. Turkey and Georgia too. Survival is in.

Maybe one day there will be an Asian union with a single Asian currency. Maybe, ultimately, a world order with a single currency that only admits democracies. One big happy island where nobody gets kicked off. Fantasy Island.

Corporate Survivor

Unlike national economies which can print money and raise taxes to survive, corporations need to use their wits to grow and survive in a dog-eat-dog world. They need to deal with aggressive competition, rising costs from both labour and commodities, fluctuating currencies and interest rates, new technologies, access to capital, changing regulations and accounting rules, class actions and Eliot Spitzer. Lots of dogs to be eaten by. Pit bulls mostly. Remember the economic concept of “creative destruction”. It comes with free markets. It eliminates the weakest and allows the strongest to survive. Survival of the fittest. And we all are supposed to benefit from the process in the long run.

Many industries are suffering from the excessive competition that comes with globalization: autos, airlines, telecommunications. And also suffering from shrinking margins as costs rise faster than revenues.

Retail is tough too. Wal-Mart, the fittest of retailers, is a voracious predator, the ultimate survivor. Sears and Kmart, the prey, merge and liquidate their profitable credit card divisions and real estate in order to survive. Toys R Us is likely next. Online retail is hurting conventional retailers. Even leading online retailers like Amazon.com and eBay aren't impervious to competition. Blockbuster, whose business is being creatively destroyed by Video on Demand, is desperate to merge with anyone and just launched a hostile bid for Hollywood Entertainment. No more late charges says it all.

GM, whose debt is a notch away from junk status, and Ford, whose January US sales just declined 12%, need some help from a lower dollar to contain pit bulls Toyota and Nissan. Too much competition in this space. Toyota already has more market share than Ford and is challenging GM for the number one spot. Do we hear a merger before it's too late? “General Ford” sounds like as good a name as DaimlerChrysler. Who's getting kicked off this island?

Like marriage, because two can live as cheaply as one, mergers are definitely in too, for the same reason. They often reduce competition, but they mostly buy time, by eliminating costs and are, if only temporarily, accretive to earnings. So Oracle acquires PeopleSoft. Procter & Gamble acquires Gillette for a whopping \$57 billion, ostensibly to get more shelf space at predator Wal-Mart, to accelerate growth in Asia, but also to reduce costs by eliminating 6,000 jobs. Sprint gets Nextel. SBC buys AT&T for \$16 billion to become the largest US telecommunications company and will cut 13,000 jobs to buy time in their waning days. Not to be outdone, Verizon is bidding for MCI. Coors and Molson merge to become the fifth largest brewer and probably won't stop acquiring on their way to survival. MetLife buys Travellers for \$11.5 billion to become the biggest seller of individual life insurance. The ultimate life insurance salesman. Tyrannosaurus Rex.

Like marriages, sometimes mergers don't work too. The Hewlett-Packard/Compaq Computer merger isn't so blissful as predator Dell gains market share on them. And DaimlerChrysler is reporting dismal earnings as its Mercedes division is losing ground to predator BMW even though Chrysler is holding up her end of the union. GM is paying \$2 billion to divorce Fiat. Good thing there were no kids.

Airlines are struggling. The industry lost \$4.8 billion in 2004. Too much competition and oppressive costs. While unions get beaten up, high oil costs and fare reductions eat up the savings. Many, like UAL, are broke and the rest are limping along. Capacity has to disappear, one way or another. Problem is, like US Air and Air Canada, they go broke only to be resurrected again. Creative resurrection. Canada's WestJet prays that ailing Jetsgo will fail. Creative religion. We're guessing the future holds fewer airlines with less capacity and, accordingly, higher loads and yields and better profits for the survivors.

In Canada, "insolvent" Stelco is being coveted by myriad predators. Voracious predator China is trying to swallow Noranda. A big bite. And some Canadian oil sands interests too. An even bigger bite.

Canadian banks have for some time been lobbying for the right to merge, to become necessarily bigger so they can compete on the world stage. Read, eliminate branches and lessen competition. Piggy banks. European banks want to combine too, ostensibly to combat predatory US giants. *Cochons*.

Gold companies struggle for profitability even with higher gold prices because of rising costs, higher local currencies and lower grades. So mergers are in. South African predator Harmony Gold, mired in continuing losses, is trying to swallow a larger prey in Gold Fields. After a tumultuous courtship, Wheaton River and Goldcorp finally merge to become the fifth biggest gold miner with a stated goal of one or two more acquisitions to become a 2 million ounce a year producer. In the gold world, as in prehistoric times, bigger is better.

To survive, even the NHL has to reduce costs and the great lockout should result in a healthier league. Survival. Other struggling sports leagues must have a watching brief. Players unions shouldn't feel discriminated against. Unions everywhere are being crushed. Wal-Mart just closed a store in Quebec because its employees deigned to unionize. Survival.

Investor Survivor

All of the above is a lot of macro reality, but we need a reality check if we're to come up with appropriate asset allocation and the themes we want to play to protect our clients and obtain a satisfactory return. The public market is one tough island. But we'll go wherever we'll be treated the best. Where we'll survive.

We think the US dollar needs to decline further, maybe another 20%, to stem the stubborn current account deficit. Predators Buffett, Gates, and Soros have bet that way too. Survivors in spades. In the end, it is conceivable the dollar won't be the only reserve currency and that oil, metals and aircraft may also be priced in Euros.

The potential for a lower dollar means we need to be more invested outside the US in markets with appreciating currencies or to hedge our US dollar exposure which, as our clients know, we endeavour to do.

Offsetting the currency risk of investing in US stocks, however, is that a lower dollar should translate into higher earnings for exporters and multinationals. Because these are usually larger companies, their earnings should sustain the market averages they dominate. Indeed, 83% of US companies in the S&P that have reported fourth quarter earnings beat expectations, compared to just 20% of the companies on the S&P/TSX. Currency effect?

While it's not yet apparent, we believe US inflation is likely to pick up: from higher import prices because of the declining dollar, from rising costs that need to be passed on, from excessively stimulative monetary policy and from the pricing power that comes from the diminished competition we foresee. It would appear that exporters to the US have not yet begun in earnest to raise prices and are suffering shrinking margins. That will give. And then domestic competitors will raise their prices too. A world awash in dollars is a pretty good start to an inflationary outcome especially if those dollars become unwanted. If the decline of the dollar accelerates, foreigners may dump US bond holdings which the Fed might have to buy or we'd suffer excessively high rates. Not a good thing when total US debt is about 300% of GDP, a level without precedent in US history. Fed purchases of treasuries might increase money supply inordinately with unavoidable inflationary consequence. Perhaps not the worst thing if it made it easier for the government and private sector to pay off their mountain of debt.

We continue to avoid medium and long-term government bonds because the risk of capital loss from bonds with yields at multi-decade lows and the risk of higher inflation and a dollar collapse make them risky propositions indeed. Not much return after taxes anyway. While rising interest rates are outright bad for bonds and not normally good for stocks, rising inflation and earnings make stocks the preferred asset choice, despite moderately higher rates. Especially after taxes. Of course, as interest rates rise, that should slow consumption and encourage savings, both desirable in order to shrink potentially unmanageable current account deficits and, in turn, restrain rates from rising too high. Foreign Central Banks, using trade surpluses to support the dollar, may also be artificially supporting bond prices though there is some evidence their appetite is waning. While the yield curve is surprisingly flat (2.5% short term, and not much over 4% for 10 year and 30 year treasuries) implying not much inflation premium and/or little anticipated growth, the spread between 10 year US Treasuries over

Treasury Inflation Protected Securities, or TIPS, has been 2.5%, which represents investors' expectations of the annualized inflation rate over the next decade. Put it all together and we keep thinking, *stagflation*.

For us, equities are still the preferred asset class. Indeed, our SVA™ work suggests the market is “on buy” and, at current interest rates, the market is over 30% undervalued. Unlike government and consumer, corporate balance sheets are in very good shape. Much of the reality we've written about is already priced into stock markets. Corporate treasurers must think their stocks are cheap too since stock buybacks in 2004 were at the highest level in almost 20 years. And there is still some \$5 trillion of cash on the sidelines looking for a home. Also, Corporate America is being induced with a new tax law, to repatriate some \$750 billion of foreign profits earned before 2003 at an effective 5.25% tax rate which has to be spent in ways that stimulate the economy. With \$300 billion expected to come back this year, it should be a lift for the stock market.

Strategic Survivor

But in the end, as the saying goes, it's not the stock market, but the market for stocks that counts, so we still emphasize our bottom up stock picking disciplines.

In an environment with potential for higher inflation and interest rates, as portfolio managers who are inclined to survival, we don't just buy any old stocks. Real estate companies should probably be avoided as mortgage rates may rise. So should utilities because they correlate to bonds. And banks, mortgage lenders and other financial intermediaries, whose spreads are being compressed by the flattening yield curve. On the other hand, resource companies still look good because commodity prices generally should stay strong for many years, being in short supply, and spurred on by growing demand from China, India and other fast growing developing countries.

Among resource stocks, we prefer oil and gas. Here's the harsh reality for oil. Cash flow reinvestment rates (the amount they put back into the ground for new exploration) for both independents and major oil companies have declined dramatically in recent years and are running well below that necessary to meet rising demand. And, demand isn't abating. Estimates for total global demand are running at about 84 million barrels per day for 2005. At the same time, China is importing oil at rapidly increasing rates (35% growth through November of last year while November alone was up over 45%, prior to the onset of the heating season). Furthermore, even US demand for oil in 2004 grew at the fastest rate in five years. The reality here is that prices could be headed materially higher simply because demand is rising rapidly and supply cannot keep up.

So a high percentage of our portfolios are in the energy group and our coterie of companies in this group are generally cheap relative to earnings and cash flow, have excellent balance sheets and great potential to grow with the drill bit. And we continue to add to our oil and gas positions purchasing: *Connacher* which has very valuable land in Western Canada's oil sands; more *Rally Energy* whose main assets are in Egypt and can double its production to 8,000 barrels of oil per day by year end; *Kodiak* which has a new major gas find in the Rocky Mountain region of Wyoming adding to its existing assets; *Canoro* with assets in India where drilling on development wells in the next few months could add substantially to its net asset

value; *Corridor Resources*—with potentially a trillion cubic feet of gas in place offshore New Brunswick and other potentially large interests in Eastern Canada; and *Sterling Resources*—with significant potential onshore and offshore the United Kingdom and Romania.

Of course, we're still holding our other oil and gas companies including *Pan-Ocean*, *EastCoast Energy*, *Canadian Superior* and *Delta Petroleum*.

Pan-Ocean is the gift that keeps on giving. Its recent drilling record is impressive and we await further results. With the potential of 100 million barrels of reserves and 30,000 barrels of oil per day of production by the end of 2006, we believe this can be a \$50 stock by that time.

EastCoast Energy is sitting on a significant pool of gas reserves offshore Tanzania and its cash flow should grow dramatically as it markets gas for turbine powered electricity production to power starved Tanzania. In the meantime, the controlling shareholder continues to buy it. And so do we. EastCoast is currently engaged in a rights issue in which we intend to participate.

We also hold an overweighted position in precious metal stocks which recently have acted poorly in line with the corrective action of bullion, though it appears a recovery is underway. In recent years, gold has behaved like a currency, mainly the Euro, to which it correlates positively some 80% of the time. So, if we believe the dollar is going lower, gold should go higher. But we also believe that gold and silver will continue to be in short supply and that ultimately they should divorce from currencies and trade like any other scarce commodity. Particularly in demand, like all hard assets should be, whenever inflation picks up.

Like our oil stocks, we believe our golds are cheap too, based on net asset values, potential earnings and cash flow and the potential to increase resources and reserves.

We continue to hold *Gold Fields*, which as we said is the target of a hostile takeover by Harmony, another South African company. We're not sure how this will play out, but Gold Fields is a superior company which has been held back primarily by the effects of the high South African Rand. But the currency that shouldn't be rising is the South African Rand. We think it will decline as short-term rates are lowered from 7.5% and, as it does, South African gold stocks will improve.

Pan American Silver is our proxy for silver bullion which, we believe, will rise significantly as the diminishing supply of it is overwhelmed by demand. While not a really cheap stock, Pan American intends to double its unhedged silver production to 20 million ounces annually and should be a winner as it capitalizes on the rising silver price. We are also looking at other silver plays.

St Andrew Goldfields is down by half after it announced it was suspending production at its Stock Mine in Timmins, Ontario. As it was developing its Clavos property to the 250 metre level objective, grades at higher levels turned out to be uneconomic without further geological development. As a result, anticipated revenues to help finance the continuing development were not available. A rights issue is being undertaken in which we intend to participate. If all rights are exercised, St Andrew should raise \$10 million, which, together with warrants being

exercised and some other funding sources, should be adequate to fund its capital requirements to the startup of production in July. Production from its Alaskan Mine should commence then too. St Andrews trades at a significant discount to its net asset value and should produce 100,000 ounces in 2006 and 200,000 ounces in 2007, which, at current gold prices, should generate cash flow per share sufficient to warrant a substantially higher price.

While metal and energy prices have been particularly strong for some time, agricultural prices—corn, wheat, soybeans, cotton and rice—have been weak as stocks of them continue stubbornly high, farm subsidies in the US and Europe overstimulate otherwise uneconomical production and Brazil and Argentina produce several crops per year. But bottoms are made with gluts, and at the margin planting intentions should diminish. In its current budget proposal, the Bush administration is proposing sharp cuts to farm and commodity programs to help reduce the deficit, which should inhibit otherwise unprofitable production. From the demand standpoint, it is well established that rising personal incomes, as in the developing world, create rising food consumption.

We think it is reasonable that agricultural commodities will finally begin to rise as will farmers' incomes. So in looking for a company that will benefit, we bought *AGCO*, the third largest farm equipment manufacturer in the world. Its brands include AGCO, Tye, Hesston and Massey Ferguson to name a few. The stock trades at a 30% plus discount to its fair value and less than 5x peak potential earnings three years out. A mere 11x multiple could double the stock price in the next three years.

Believe it or not, we make mistakes too. That's reality. *Conexant* and *UTStarcom* were both sold as fundamentals worsened following their purchase. While the potential reward from both of them remains high, the risk has risen to levels unacceptable to us.

These losses were somewhat offset by the quick gain we made in *WellPoint*—a major US health insurer—whose stock was battered by rumours Eliot Spitzer (his is a killer reality show) was about to attack insurance commission structures for HMO's as he did with P&C companies. As it turns out, it was merely a rumour and the stock bounced back smartly. Then, the California insurance regulators changed their previously negative view on the proposed acquisition of *WellPoint* by *Anthem* and the stock jumped materially.

Nextel's acquisition by *Sprint* should be a positive. We believe the combined company should grow its earnings by double-digit rates. The synergies from the combination are valuable both from cost savings and cross selling. *Nextel* gets access to *Sprint's* ubiquitous broadband network and *Sprint* can utilize *Nextel's* expertise in the business market and technical functionality which provides it the highest margins in the cell phone business. At 16x forward earnings, the new company remains undervalued.

Kingsway Insurance has also performed admirably. The stock has risen more than 40% in the last year as earnings have grown smartly and continue to grow. Yet *Kingsway* still trades at about 7x earnings compared to its peers which trade at about a 50% higher multiple, making *Kingsway* a continuing value.

For our income accounts, we've added: income trust—*Custom Direct*, a US cheque printing company; *Lanesborough*, a Canadian REIT holding primarily apartment properties mainly in northern Canada; *Transtel units*, a secured debenture in a Colombian telephone company and *Call-Net* (Sprint Canada) bonds. Bond positions in *Saskatchewan Wheat Pool* and *Inmet Mining* were sold and redeemed, respectively, after substantial capital gains. Income trusts, *General Donlee* and *Specialty Foods*, both declined heavily last year. We sold the former for a tax loss as its fundamentals had deteriorated. *Specialty Foods*, on the other hand, has rebounded smartly and we continue to see good upside from current prices.

Economic and market cycles tend to be reflected in other aspects of society. The bull market was accompanied by short skirts. The Bubble spawned huge volatility, financial excesses, extravagances, fraud, massive losses and business failures. It was reflected in society generally in what we observe currently to be a high level of greed and of vulgarity in popular culture. Rap music titled, "Kill Whitey." Especially if he's a money manager. Idolatry is in, as in *American Idol* and *Canadian Idol*. And programs that demean—The Osbournes, Jerry Springer and Howard Stern. A spate of reality TV shows like *Survivor*, *Who Wants to Marry a Millionaire*, *Big Brother*, *Fear Factor*, *The Amazing Race* and *The Apprentice*. Popular not only, we believe, so the audience can delight in the success of the sole winner, but also because it perversely relates to the many losers and the viewers' own feelings of mediocrity. Like other fads, reality shows won't survive for long either. Though we hope short skirts are here to stay. Psychologists, sociologists cum money managers. Impressive, huh?

Unlike TV viewers, as money managers we don't relish the losses of others. But we are determined to survive, and to win, which means staying real and protecting capital. Our SVA™ work helps as a reality check too, keeping us away from stocks until the "all clear" sounds. Playing safe. Survival for us means intelligently managing our clients' portfolios, so we never have to hear those words immortalized by Donald Trump: "You're fired!"

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