



VALUE TRUMPS FEAR

You should have now received your September statements. Dismal reading indeed. October thus far is awful too, in the face of huge volatility—the TSX Venture Exchange down 52% in September and October to date; the Dow Jones Industrials, 30 of the biggest companies in America, recently down over 18% in one week; the S&P 500 down 9% in a day, the biggest one day drop since 1987. Accordingly, the Volatility Index has been hitting record highs reflecting the high level of investor fear and setting up a good bottom. A free-fall as we've just witnessed is usually seen at the end of bear markets when investors capitulate. Record redemptions from mutual funds and hedge funds. Off-the-wall margin selling. Unwilling sellers forced to pawn their favourites. We always contended bear markets end when the selling abates and a vacuum develops. When the redemptions, margin selling and tax loss selling are done, soon we think, look out above.

In the face of this, we think the final low was potentially made on October 10th at 7773 on the Dow, and that the markets should, in a volatile manner, start to recover from here. And, if the market is truly bottoming, we should recover smartly. Big ups typically follow big downs. The average bear market loss since WWII has been 26% followed by an average 88% bull market recovery. After August 1982, when the S&P 500 had lost 27% over 16 months, 6 months later it was up 45%.

The Forest For The Trees

Why believe us now? Well, up until a year ago, over 9 years since inception, we performed admirably through all market environments. That included the meltdown in 2000-2002 when the tech bubble blew up but we were significantly short for client accounts—outlandishly overvalued tech stocks and buying, and sometimes trading, ignored cheap stocks with the use of our SVA™ work.

We've already written several postmortems about our recent poor performance. Most money managers and, for sure, most value money managers have had poor performance. After all, this decline started with stocks not being overvalued. Our friend, Murray Pollitt, of investment dealer, Pollitt & Co., student of financial history extraordinaire, said, "This has been the only stock market dive in recent generations caused by a bank imposed credit crunch; all the others were a result of a government squeeze, as in taking the punch out of the punch bowl."

If you didn't go to cash or go short you didn't escape. If you focused on individual undervalued stocks and not the potential for an overall market meltdown from the credit crisis, you didn't escape the carnage. You needed to see the forest, not the trees. Small caps were the worst but big caps suffered too. Some of the biggest names: GE, Research In Motion, Citibank, Merrill Lynch, Merck, Pfizer, United Healthcare. Many of the biggest names went to zero or almost zero: Lehman Brothers, Bear Stearns, AIG, Fannie Mae, Freddie Mac.

Veteran U.S. investment advisor, Don Hays, recently confessed that this was the first time in 20 years that all of his components—Psychology, Monetary and Relative Valuation—were in solid shape, could buffer any shock, and didn't work, keeping him fully invested too. He says his "historical examination had never encountered a shock such as we've experienced in these last 14 months". But, he goes on to say that his Asset Allocation "shock absorbers" are now "in its most powerful condition".

Renowned U.S. money manager and Forbes contributor, Ken Fisher, writes to his investors, "We certainly were bullish and got this period wrong. Of course, we weren't alone. The chief strategists at the major brokerage houses and money management firms we compete with were also not bearish. That is no solace to you."

So, even though most money management firms missed the forest too and were down, we have been worse, from our concentration in smaller cap companies which we perceived to be, by far, the most undervalued. And still do. Imagine, underperforming with over 50% invested in energy when oil and gas reached record levels and the big cap energies were the best performing group.

It's In The Market

Clearly the economy is slowing. Housing prices continue to decline. Foreclosures are rising. Housing starts are falling. Unemployment is rising. Commodity prices are declining. Consumer confidence has plunged and retail sales are sluggish, down 1.2% in September. Auto companies are struggling. Credit remains tight. U.S. Industrial Production fell 2.8% in September compared to August which was itself down 1%. Corporate earnings are declining with profit growth, obviously, most negative in the financial sector. And the economic news going forward for the next few months should not be uplifting.

But the real news for investors is that it's all "in the market". And who doesn't know it? And that the fear of the future, of the worst, of the unknown, is palpable. Borderline hysteria.

Closer To The Bottom Than The Top

What we do know is that even as the economy deteriorates there are remedial forces at work. Housing is becoming more affordable and the government will ultimately make sure that mortgages are available. Housing demand will come back when consumers believe they're likely not to lose. Housing inventories are declining; housing starts and building permits are too; new home costs are 30% higher than existing home prices; inflation may pick up—all of which suggest we could see the U.S. housing correction over sooner than is generally believed—maybe by year end. Just reported was that Southern California home sales jumped 65% in September, the biggest year-over-year increase in 20 years, as buyers took advantage of foreclosures to snap up bargains.

The automobile fleet is aging and will ultimately have to be rejuvenated. Older houses may have charm and character and can be rejuvenated. Older cars are clunkers and become costly to maintain. GM and Chrysler are talking. Maybe cars will become more affordable too. Credit for houses and cars will become available for those who can afford it, at lower rates. Unlike the foolishness that previously prevailed when those who couldn't afford them got credit nonetheless. Housing legislation will provide \$300 billion to insure mortgages with an FHA program to lend to the subprime market.

Savings rates in the U.S. are rising, big time. Interest rates are declining. The Fed just cut Fed funds by a half-point (to 1½%), as did most Central Banks around the globe, and are likely to ease further. In Canada too, and another quarter-point today. Longer term rates have started to rise. A steeper yield curve should encourage bank lending and stimulate bank profitability. If stocks are a screaming buy, bonds are likely a short.

Some fiscal stimulus to U.S. consumers has been provided and more is on the way. Consumers will have more disposable income from lower food and energy prices, and enjoy lower prices, generally, as demand wanes and competition heats up. A virtual tax cut. A rising stock market itself will increase consumer wealth and sentiment. \$8 trillion has been lost in U.S. stocks, lots to retrace.

The U.S. trade deficit (at about \$59 billion for each of August and September, almost 12% better than the worst in October '05) should continue to shrink from imports declining faster than exports (at record highs, more than a 100% increase since early '01). So too will the current account deficit as the U.S. becomes a more attractive place to invest. A lower dollar has helped, and we think its recent rally will be short-lived as foreigners ultimately will want fewer U.S. treasuries when the U.S. budget deficit inevitably rises from its current \$500 billion this year to, say, a whopping \$1 trillion. The tradeoff is that a lower dollar, down nearly 40% on a trade-weighted basis since '01, will make the U.S. more competitive for its exporters and multinationals, boosting their profits, helping shrink the trade deficit and adding to GDP growth. On the other hand, it will also add to inflation as imports become more expensive and allow domestic companies to raise prices. U.S. labour productivity is good and should improve as companies cut costs and merge. Improving productivity will help U.S. competitiveness.

Corporate profits are still respectable, and contrary to popular perception, U.S. corporations, other than financials, are very liquid. Look for share buy backs and mergers.

Pedal To The Metal

Monetary and fiscal stimulus is occurring generally throughout the world. In the slower growing industrialized world and in the faster growing emerging countries such as China and India. The pedal is to the metal. The law of unintended consequences may be at work. The monetary base and supply of money is exploding and whenever its “velocity” picks up with the ultimate revival of normalized credit supply and demand, inflation should pick up too. Merrill Lynch Economics recently noted that the Fed continued to ease and cut rates in 1991 and 2001 even after the recession ended, a harbinger of excesses to come, including inflation. A plus for our commodity stocks.

Nothing To Fear But Fear Itself

You might say, what if it's different this time. Maybe like The Great Depression. Get serious, it is serious, but nothing like The Great One. From 1931 until 1941 the U.S. had 25% unemployment—and no unemployment insurance and no social security—compared to 6.1% unemployment today and unemployment benefits to allow spending even if you're not working. The biggest bears, like Nouriel Robini, Professor of Economics at NYU, thinks, at the worst, 9% unemployment may be coming. In the '30s there were 5,000 bank failures with billions lost by depositors and no FDIC insurance. Today there are under 20 banks gone and bank deposits everywhere being insured. No one has lost a dime, yet they're still stuffing it in mattresses. In the '30s there was a 30% GNP contraction while today 2008 GDP is still up and might only be down marginally over the next couple of quarters. Even the bears think '09 world GDP will be up 3%. In the '30s there were 50% duties on imports (the infamous Smoot-Hawley Tariff) and a huge drought that led to the Dust Bowl in an economy heavily dependent on agriculture. Today we have more encouragement of free trade and the huge secular growing demand of evermore capitalistically oriented emerging countries such as India and China and Russia and Brazil. Maybe in the '30s there were Grapes of Wrath, but today it's still Grapes of Bordeaux. At the worst, Baby Duck.

In our last letter we pointed out that the stock market was a discounting creature which was discounting everything and the kitchen sink. The Great Depression, the “abyss”, the “catastrophe”, the “meltdown”, and all the other fear inducing catchphrases we hear on TV and coming out of Washington. All that's left to discount is the bubonic plague and the invasion from Mars. Franklin D. Roosevelt, President during most of The Great Depression, author of the New Deal, said, “There is nothing to fear but fear itself.” Indeed psychiatrists today are having a field day with anxious investors suffering from, as one eminent psychiatrist noted, “catastrophobia”.

Well known analyst, Leon Tuey, points out that “given the aggressive monetary easing, the dramatic steepening of the yield curve, and the two months back-to-back increase in the Ratio of Coincident/Lagging Indicators (which always leads an economic bottom by two to four months or coincident with an economic bottom), the economy will improve sooner than most think.” Tuey also notes, no one is talking about recovery, only the slowdown, so we might see a recovery sooner. A valid contrarian notion. In a conference call last week he said that he thought stocks were now being offered up on a “silver platter”. No mincing of platters there.

Fear Vs. Value

We think the market is bottoming or has likely bottomed because the mood was so pessimistic, because the fear was so acute, because there’s a record amount of cash out there—\$4 trillion in money market funds and a record 27% of the value of S&P stocks in cash, not to mention all the lumpy mattresses of those mistrustful of banks. Pollitt writes, “Just as Nortel was once a ‘one decision’ stock, so cash is now viewed the same way.” But most important the market is bottoming because stocks are cheap. Don Hays notes “it is ALWAYS valuation that stops these totally irrational, emotional panics”, and points out that the average stock is being valued at levels only reached on two other occasions—1974 and 1982, the two best times to buy in the last 40 years and maybe ever.

“Fear” and “valuation”. You’ve got to love them. Pollitt says, “Back up the truck, this is the best time to buy stocks since 1987. If anything, better. There has been more panic during this downdraft than there was then, and opportunity goes hand in glove with panic.” Panic and opportunity.

Don Hays comments that the options specialists traders (the “pro’s”, who are invariably right, have only displayed this level of bullishness at the bottoms in '82, '90 and '02.

Ken Fisher writes, “Stocks are super cheap, the cheapest adjusted for tax rates and interest rates in any of our clients’ adult lives, at a time people can’t see good things ahead.” “Super cheap” and “can’t see good things ahead”. Panic and opportunity.

Insiders are already taking advantage of the values. Insider selling has dried up and there is sporadic buying, though even insiders have suffered margin calls.

The market will inevitably turn up. Since 1956 we have had 12 bear and 11 bull markets. The average bear market lasted 9 months losing 25% and the average bull market lasted 47 months and gained 127%. The bigger the down the bigger the potential up.

Risk Vs. Reward

Stock markets globally are remarkably undervalued. We believe Canadian and U.S. stocks have rarely, if ever, been cheaper relative to their potential returns. S&P Industrials are getting close to their replacement cost book values. Low interest rates relative to earnings yields continue to make stocks exceedingly cheap. And our holdings are outlandishly cheap. Meaning little downside risk. Against that our one-year targets and three-year annualized potential returns are extraordinary. As we have previously noted, many of our companies' operations are demonstrating record performance with good balance sheets, notwithstanding the poor economic climate.

We also believe that commodities are bottoming, that in many cases supply will be cut back as marginal production shrinks, including of oil and gas and gold.

If oil and gas are bottoming, as we believe, our very cheap stocks in that sector should reflect it. The world is still short of oil and new supply is hard to come by. Even if the recession slows demand in the U.S. and Europe, demand continues to increase in China, India and the Middle East. And an OPEC meeting is scheduled for later this week, likely resulting in a production cut. The clearly evident worldwide reflation should translate into more inflation. So should a lower U.S. dollar. Kiril Sokoloff of 13D Research, one of our favourite publications, believes the rescue of the global financial system will prove to be inflationary. He also points out that the recent decline in the prices of food and energy is very stimulative—at the same time that the U.S. government is running the largest deficit in its history.

Gold is breaking out, notes 13D Research, in dozens of currencies, (including Canadian dollars) even though it is weaker in U.S. dollar terms. Of course, the weaker dollar we expect, normally implies higher gold prices too. In a recent interview, Warren Buffett also worried about the implications of the current reflationary measures, saying, "Inflation is a likely consequence out of what's going on now."

Ultimately, as the market and our stocks recover, we intend to migrate a larger portion of the portfolios to more liquid, large cap names. Many of those large cap companies have now reached levels of cheapness we might otherwise have embraced but none have the upside potential of our favourite small cap names. *Corridor Resources* and *Orca Exploration* are 25¢ dollars and therefore could increase four fold, while our two largest cap holdings, *Walgreen* and *United Technologies*, are only 50¢-60¢ dollars. Though, admittedly, our SVA™ work is more effective in allowing us to get in and out of larger cap stocks than the smaller cap names.

Positive surprises, the commercialization of Corridor's shale play or the monetization of Orca (both of which we believe could happen over the next year) obviously have much more price impact than anything that could positively occur to Walgreen or United Technologies. We need to stay with these small caps for the ultimate recovery. Particularly because small caps inevitably outperform on the recovery because of the vacuum that occurs on the way up, just as it did on the way down. In the last recovery, from the October '02 lows, the TSX Venture Exchange outperformed the TSX and S&P 500 by a factor of 2.5 times in the first year of the recovery.

As Good As It Gets

The whole U.S. market is around 70¢ on the dollar of value now. The P/E multiple for the Value Line Index (the 1700 largest U.S. companies equally weighted) is 12x which is well below its '07 peak of 19.7x, and below its '02 bear market bottom of 14x, and 17x which we believe is the lowest it ought to be priced. The median price to Fair Market Value for our own portfolios puts our stock holdings at a 25 cent dollar.

In our careers we've seen the odd stock fall to 25 cents on the dollar, but never an entire portfolio of stocks. Our stocks are being marked down as if their status as "going concerns" is in question. While limited access to capital threatens to severely impact a few of our holdings, 90% of our stock holdings should be unaffected. But, investors fear uncertainty more than anything else so the indiscriminate selling of shares has continued.

Our key oil and gas holdings are prime examples. Each has a solid balance sheet with no immediate capital needs. Yet, they've fallen, on average, to 20 cents on the dollar.

For example, our largest holding, Corridor Resources, now has a market cap of \$200 million, though based on our appraisal, we believe it should trade at \$12 giving it a market cap over \$1 billion. At a minimum, the company should trade above the discounted present value of its 2P (proven and probable) reserves—twice the company's current price. And, that allows zero value for further development of the Hiram Brook resource and the material upside potential from the company's exploration prospects. If natural gas prices were to fall well below the current \$7 price, the company might need to cut back on capital expenditures to make sure spending does not outstrip cash flows in a capital constrained world. The company is on a solid financial footing—next year's cash flow is expected to be at least \$80 million, the company has no debt and working capital of \$20 million. At 2x cash flow, 80% of book value (having spent virtually its entire trading history over the last 8 years above 2x book value until the last couple of months), 50% of 2P reserve value and 15% of its risk adjusted Net Asset Value, Corridor should not persist very long at this ultra-low valuation level.

As good as it gets. High reward, low risk. Value well above trading prices. And, well financed, a clean balance sheet, material cash flow, no current needs to access additional capital, plus a consistent record where they've found gas virtually every time they've drilled for it.

Our other large oil and gas holdings aren't dissimilar. Orca Exploration trades at 25 cents on the dollar, has a debt free balance sheet and substantial and growing reserves. With 1.25 TCF of 2P reserves and substantial additional resources, we estimate Orca has intrinsic value in excess of \$12 per share. As a monopoly supplier to the power starved Tanzanian market, other companies should be extremely interested in Orca's growing assets.

Canadian Superior and *Petrolifera Petroleum* are 20 cent dollars with world class assets. *Canadian Superior's* two recent discoveries in Trinidad added about \$5 to the company's asset value (now over \$8) yet the share price has dropped, like all the others. There should be significant interest by major energy companies in the very valuable Trinidadian assets, even if the stock market isn't willing to recognize the value. *Petrolifera's* Argentinian assets alone are worth more than 4 times the share price. At around 70% of book value and 1.5x expected cash flow of more than \$80 million, the company is absurdly cheap, especially given the exploration prospects in Colombia and Peru.

Sterling Resources and *Canoro Resources* both have spending needs in '09 which require capital. That said, each has no debt, asset values far in excess of prevailing share prices and could access capital or delay projects until capital is readily available. We expect little dilution. *Sterling* has assets we believe are now worth more than \$500 million yet the market prices the entire company at only \$85 million. And, cash flow in 3 years is expected to be more than \$400 million per year from oil and gas they've already discovered. They just hit on two more wells in Romania and another in the North Sea. *Canoro's* market cap has dropped all the way down to \$34 million (34% of book value), yet the company has approximately \$20 million of cash, \$10 million of cash flow, \$170 million of 2P reserves and a total risked asset value that's over \$300 million (10 times the prevailing market cap).

In the above examples we've pointed out the enormous gap between today's prices and the underlying asset values of the businesses. The closing of the enormous gap should yield high returns from these levels. Plus, these companies are all capable of high growth rates which should further add to the returns over the years to come.

Our other key holdings trade at big discounts too and should have no need for capital in the near term. *Etruscan Resources* trades at one-third of our appraised value, *United Technologies* is a 60 cent dollar and *Walgreen* a 50 cent dollar.

We hold other oil and gas holdings and gold shares that are also 20 cent dollars, on average. One smaller oil company holding that even trades at a 30% discount to the \$25 million cash on its balance sheet. The company has no debt, will spend about \$6 million per year for the next couple of years and has 2P reserves well in excess of \$200 million. Hard to see the risk in that, easy to see the potential reward.

When 25¢ dollars rise to their FMV, investors would get a 300% return. On the way to the old portfolio highs as normalcy returns.

We have done some selling over the last couple of months mostly for tax loss purposes and attempting to eliminate or reduce positions in holdings which have current requirements for capital to advance their businesses. And, we're redeploying the proceeds, where we can, into other bargains, such as *Corridor*, where the risk is less but the reward is equally compelling. We are taking the tax losses thoughtfully even if it means foregoing upside potential on those names. Needless to say there is no shortage of other names in which to reinvest or even to buy the same names back in 30 days after sale, but we want to offset current year capital gains and have the ability to reclaim capital gains taxes paid in prior years.

A Time To Buy

This is a screaming time to buy. The pundits we respect are saying so, including the ones we've mentioned herein: Don Hays, Ken Fisher, Leon Tuey, Murray Pollitt and Kiril Sokoloff.

But so also says the greatest investor of our time, Warren Buffett, and we are enclosing his OP-Ed piece from the Oct 17th edition of the New York Times entitled, "Buy American. I Am." So if you don't believe us, believe Warren. We know, as he knows, that "value trumps fear." It always does. And as a committed bridge player he gets "trump". Now if we can only get him to "Buy Canadian" too.

Herb Abramson and
Randall Abramson, CFA
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