THIRD QUARTER LETTER 2008

THE GLOBAL CREDIT CRISIS: The freezing and thawing of liquidity

What a difference a few months make. In July, the SEC implemented temporary rules against short-selling shares of leading financial companies for fear that declining stock prices would lead to a loss of confidence in these institutions which had begun taking large write-offs due to the meltdown of the US residential mortgage market. This triggered a massive unexpected unwinding of positions by hedge funds that were shorting banks, but were heavily invested in commodities on the thesis that world demand had decoupled from the US and as a hedge against the US dollar. This tsunami of selling energy, gold and mining related stocks, and eventually shares in other materials companies such as in agriculture, is still making its way through financial markets today, and is now hitting all industry sectors, as well as the value of currencies such as the Canadian dollar. While this helped pour cold water on the flames of input-cost inflation, it temporarily propped-up bank shares helping markets to rally in August, until the Fed took-over such venerable institutions as insurance giant AIG and the two largest mortgage lenders in the US, namely Freddie Mac and Fannie Mae, in September.

Since then, more commercial and investment banks began to fail, as a crisis of confidence spread among the most highly leveraged companies in the world, namely globally renowned and supposedly “blue-chip” financial institutions. As a result, banks began to mistrust one another and stopped lending funds among themselves (as reflected in the high inter-bank lending rates such as LIBOR), in what can best be described as “an institutional run on banks”. This fear started to filter its way to retail depositors who felt that their money was no longer safe in savings accounts, causing banks to hoard cash and restrict lending to their customers. Money market instruments such as commercial paper seized-up as even the most credit-worthy corporations could no longer borrow to meet their short term obligations.

This freezing-up of liquidity throughout the entire debt market began to affect normal day-to-day trade between companies and quickly necessitated drastic government intervention in the form of guarantees on retail deposits and inter-bank loans, purchasing and lending against illiquid assets, and finally culminating in massive injections of hundreds of billions of US dollars, EUROs and Pounds into some of the world’s biggest banks in what basically amounts to an industry-wide quasi privatization. Luckily, in Canada, our banks are among the best capitalized in the world and have been spared this embarrassing fate. These measures should be sufficient to provide the antifreeze required to get funds flowing again, and will also depend on the magnitude of future write-downs in the banking sector.

EQUITY VALUATIONS: Out the window

The credit crisis caused many highly leveraged and illiquid financial instruments, mainly structured around residential and commercial mortgages, high yield loans, and consumer debt, to lose value or become unsalable, which in turn caused financial institutions to embark on a worldwide deleveraging process. This led to a massive disposition of the more liquid securities, namely equities. This relentless forced selling of stocks due to hedge fund liquidations, mutual fund redemptions, financial institutions shoring-up balance sheets, broker margin calls, and generalized panic has caused unprecedented declines in stock market indices across the world, ranging from -35% to -70% year-to-date in most developed markets. Clearly, a major global recession (and then some) has already been priced into most markets. The credit crisis which resulted in the freezing-up of liquidity has not only caused forced selling of equities, but has also prevented the natural purchasers of equities, namely institutional investors,

from entering the market to buy shares. With nearly every stock in every industry being sold indiscriminately at any price, some companies' valuations are verging on the ridiculous. Many solid growth companies are trading at low single digit multiples to free cash flow, and some are even trading below hard book value or close to cash value (meaning that you can almost buy the company for free as no value is attributed to the business). Consequently, companies are buying back their shares.

Clearly, with some investors forced to sell at any price, many companies' values based on current stock quotes, are virtually meaningless. Stock market quotes are the most recent prices accepted by marginal sellers, not by knowledgeable or strategic investors, and particularly in these volatile markets, do not reflect the true value of a business. This is evidenced by an increasing number of transactions taking place, particularly among smaller companies, whereby either management or savvy investors have begun to offer substantial premiums over the recent stock quotes, to purchase all or parts of companies. Nonsensical valuations create huge opportunities for investors to generate attractive returns over the ensuing years. However, one has to be patient, have a long term time horizon, and not become obsessed with the short term gyrations of the market, to profit from these anomalies. Often, when times look the bleakest, one cannot find the bottom or see a way out of the crisis. But by the time one is able to look back and identify the bottom, the market will have already substantially risen, anticipating a recovery.

OUTLOOK: After the storm

The drastic measures taken by G7 governments should help shore-up bank balance sheets and facilitate lending among banks and to worthy borrowers. However, it will take some time to get global credit markets working smoothly again. Unlike 1929, governments and central banks have begun using their tools to restore order in a more coordinated and timely fashion. As more normal credit conditions resume, liquidity will start to flow again, albeit slowly and more prudently than during the excessive follies of previous years. Once this and investor confidence return, equity markets will rebound sharply.

Meanwhile, with hedge fund liquidations expected to continue until the end of the year, long term investors who are staying the course, continue to weather the storm, while those on margin are forced to sell at distressed prices. The massive deleveraging process and ensuing global credit contraction is deflationary, and in such an environment, debt is the enemy. This is none too evident than in the real estate sector, which we have long avoided, as well as financial institutions which we had limited to a few Canadian banks. Other victims of deflation, commodity prices, have already dropped precipitously causing many resource companies to postpone or abandon new projects. This decline in capital spending will eventually result in commodity prices rising with a vengeance, as a lack of new supply will be far outstripped by renewed global demand. Furthermore, the massive liquidity infusion into the global financial market will manifest itself in inflation as this liquidity works through the system.

One recent beneficiary of the crisis has been the US dollar, which has been driven up due to short covering, a flight to treasury bills, and the anticipation of lower interest rates in Europe to help revive a slowing economy. Panic buying has propelled the US dollar to overbought levels, creating a unique selling opportunity to convert US dollars into Canadian dollars at very attractive rates. We expect that the trillions of US dollars that need to be printed to fund the crippled US banking industry will cause the US dollar to resume its long term secular decline against most other currencies, leading to import inflation in the US. We expect the Canadian economy to slow down, but fare much better than the US, as Canadians are in better financial shape that the spent-out US consumer.

Although nobody knows how long and deep this global economic slowdown will last, we do know from experience that stock markets rise during recessions, anticipating well in advance renewed economic expansion. Most stock markets gains occur very quickly, as funds return to the markets in a panic of greed, just as they left in a panic of fear. Currently, we have reverted back to an era where the yields on many dividend bearing stocks are greater than on bonds, offering one of the most compelling opportunities to purchase equities in over 50 years. Equities also offer an inflation hedge, as companies benefit from the rise in value of their assets while the purchasing power of paper money declines. Meanwhile, we continue to be selective and focus on Canadian companies with high profit margins, healthy cash flows, low debt levels, strong domestic franchises and sound management, characteristics we have always favored. We also prefer companies that have minimal exposure to the US consumer and that distribute meaningful dividends, so we are paid to wait out the storm, and are well positioned when markets rebound.

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