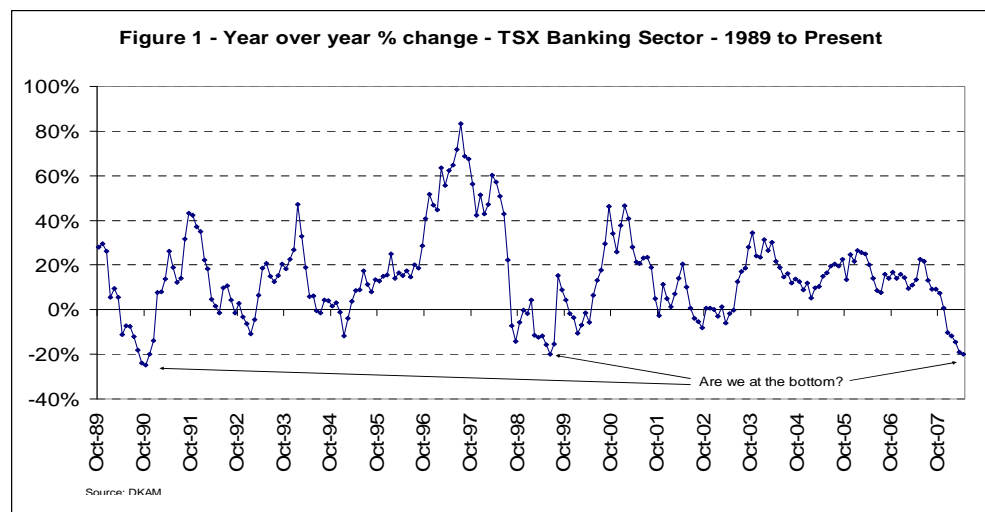


The fine art of bottoming

It's been a long winter but spring is definitely in the air. As people living in the Toronto area can attest, this past winter has felt like an endless series of storms with near record levels of snow fall. Participants in global capital markets have endured similarly nasty weather over the past three months that culminated with a particularly severe squall around St Patrick's Day. This of course was the day that the world awoke to the news that Bear Stearns had been bought by JP Morgan with the assistance of the US Federal Reserve. This day is now being referred to as "the day that the Bear died" and the double entendre (Bear Stearns/Bear Market) is not accidental. Market bottoms often occur in conjunction with a major institutional failure and they do so for two important reasons. Firstly, "institutional failure" tends to be the catalyst for widespread efforts on the part of governments and regulators to fix the problem, whatever it may be. Secondly, "institutional failure" tends to create selling climaxes that lead to the lowest valuations over the course of the cycle. From our perspective, the recent weakness has allowed us to amass substantial positions in Canada's best managed financial services companies at what we view to be attractive valuations.

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Canada is looking good! Looking beyond the short-term issues facing the stock market and the economy, the outlook for the financial services sector, from the perspective of a Canadian investor, remains bullish. The two biggest factors or influences on the global economy today are the sub-prime financial mess and the commodity boom that is being driven by the industrialization of the BRIC (Brazil, Russia, India and China) nations. On the negative side of the ledger, the sub prime fiasco has hit Canada, but for a variety of reasons we have been "relatively"

unscathed and the “material” impact of the financial crisis on Canada’s major financial institutions has been modest. This is in stark contrast to the US (think Citigroup, Countrywide, Bear Sterns, etc), the UK (Northern Rock) and Europe (UBS, SocGen) which have taken very large hits. On the other side of the ledger, Canada is extremely well positioned with respect to the global commodity boom given our massive and accessible resources in every major commodity including oil, natural gas, potash, iron ore, coal, timber, grains, nickel, uranium, gold, and silver. Indeed, Canada is in the midst of a prosperity boom that probably started in 2003 and should last another ten to fifteen years.

If we are so bullish on the commodity industries, should we not just buy commodity stocks? There indeed is merit to this idea (and if you are even thinking about it may we recommend Sprott Asset Management, which we discuss later in this note). However, given the relatively small number of financial institutions that dominate our economy, it is arguable that buying the “financials” is an even better way to play the commodity boom than buying the commodities themselves. For example, while you and I might struggle to identify the next big oil or gas play in Canada, we can say with almost complete certainty that, whatever company this turns out to be, it will trade its shares and raise its equity through the **TSX Group**. Of course, before the said company can go public it will need a transfer agent (**Olympia Financial, Grey Horse Capital and Valiant**, a division of **CWB**, dominate this space). This hypothetical company will also need an investment banker, and there is a high probability they will choose alone or as part of a syndicate either **GMP** or **Canaccord**. Of course, a widespread commodity boom will require people who will be well paid and these people will buy houses (think **Home Capital, Equitable, CWB** and **First National**), and these homes (plus vehicles and pets) will need to be insured (think **EGI, Northbridge and Pethealth**). And of course, vast amounts of wealth will be created by individual investors who will need managers for this said wealth (think **Gluskin Sheff, GMP, Canaccord and Sprott**). Thus, any boom that occurs in Canada that is widespread will undoubtedly include a broad swath of Canada’s finest and best managed financial institutions – which has been and remains the focus of our fund.

The magic of compounding

Do you believe in magic? In our view, the long-term outlook for the Canadian financial services industry is extremely positive, but this statement needs to be converted from a statement into an action plan. So how do we do this? The answer is through the magic of compounding. The so-called magic of compounding occurs when an investment is allowed to grow for many years at a high rate of growth, with the result being a many fold increase in the initial investment. Indeed, we believe that the Holy Grail for equity investors are stocks that can grow at relatively high rates on a sustained basis. Thus, the magic of compounding requires two elements – a reasonably high rate of return and a consistency of that rate of return. The essence of this approach can best be understood by understanding what return on equity is and why it is so important.

What is return on equity? Investors will often hear financial analysts referring to a variety of “rate of return” measures and in our view the best and most straightforward of these measures for investors in financial services stocks is return on common equity (ROE). We define ROE as the net profit available to common shareholders

divided by the average shareholders equity for the year. Equity in this context is the net worth of the business, which is derived by subtracting the liabilities of the business from its assets. What's left over is equity. Thus ROE is how much a company earns in a year relative to the average equity it has invested in the business. ROE can therefore be viewed both as a benchmark for how well a business did in a given year and also as an indication of the enterprise's ability to compound wealth.

Financial services CEOs are fund managers. The simplest way to understand this concept is to assume that all financial services CEOs are fund managers. This may seem a stretch but given that most financial services companies' balance sheets consist of financial assets (cash, stocks, bonds, and mortgages) the CEO's really are like asset managers. Thus, shareholder equity is tantamount to the net holdings of a fund and book value per share is no different than NAV per share. When one looks for a fund manager to manage money, one hopes to find a manager who can grow the NAV at a high and consistent rate. In the context of the DKAM fund, we also seek to find CEOs who can do exactly the same thing with their assets under management. Thus we view ROE and the growth of book value per share as being analogous to the annual returns of a fund manager and growth in NAV.

Comparing Sprott and Home. Understanding the parallels between a great fund manager and a great CEO of a public financial services company can best be understood by comparing the long-term track record of two superb asset allocators, namely Eric Sprott of Sprott Asset Management and Gerald Soloway of Home Capital. Figure 2 below compares the annual returns of each manager over the past decade, one in the context of a fund (Sprott) and the other in the context of a financial services company (Soloway). As we can see, both managers have superb long-term track records with Sprott enjoying a CAGR of 29.8% versus Soloway at 26.0%. However, it is also worth noting that Soloway's result was achieved with less risk (standard deviation) and thus Soloway enjoys a Sharpe Ratio of 5.6 versus Sprott at 1.2.

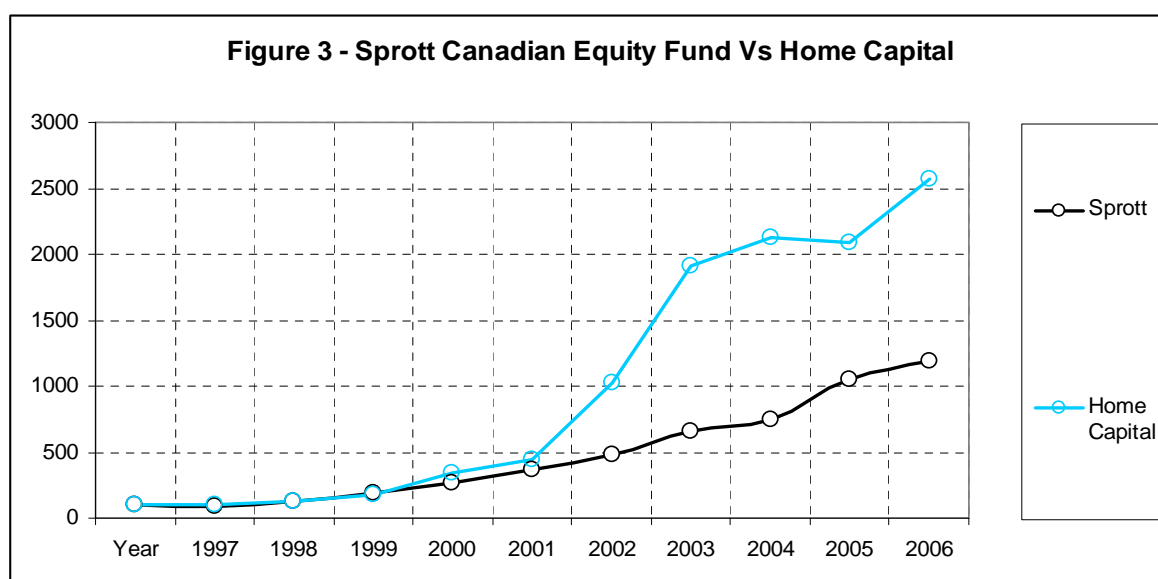
Figure 2 - Sprott vs Soloway

Year	Sprott % Chg (NAV)	Soloway ROE (%)
2007	13.8%	28.6%
2006	39.6%	27.4%
2005	13.2%	31.8%
2004	37.9%	31.4%
2003	30.0%	27.4%
2002	39.3%	24.3%
2001	43.7%	23.8%
2000	44.0%	23.2%
1999	53.4%	21.8%
1998	-16.6%	20.7%
Geo Mean	29.8%	26.0%
STD	20.1%	3.8%
Sharpe	1.2	5.6

Source: DKAM based on Sprott Canadian Equity Fund Series (A) and Home Capital annual reports

Home run. Of course, what makes these numbers in the preceding figure really exciting is what it means for the investor. In the case of the Sprott fund, \$100 invested

at the start of 1998 would be worth \$1190 at the end of 2007. We believe this is the best 10 year track record of any fund manager in Canada. In the case of Soloway and Home Capital, the situation is a little more complicated because while the ROE is analogous to a fund manager's performance, the price one pays for Home Capital is not its NAV. Investors in Home Capital buy a stock that trades on a constantly shifting multiple of earnings and book value and thus if you buy it at a low multiple, you can do even better than the long run ROE suggests. Thus, while Home Capital's ROE has compounded at a rate of 26% over the past ten years, the stock has actually risen much faster. From an investor's perspective, \$100 invested in Home Capital at the start of 1998 was actually worth \$2571 at the end of 2007 or close to a "26 bagger" over ten years. It is although worth pointing out that the Home Capital returns exclude the dividends that have been paid to investors since 2001.



How high does ROE need to be in order to be considered high? Most investors now understand that a high ROE is better than a low ROE, but what constitutes a good or high ROE? In our view, any rate of return must be seen in the context of the cost of capital. In its simplest sense, a company's cost of capital should be viewed as the cost of renting its capital for the year. Thus, going back to the Home Capital example, if Soloway was to rent \$100MM of capital for the year from his investors, we would say that the capital has a cost (its rental fee for the year) and for Soloway to be considered a good financial manager he would need to earn an amount that was at least equal to the annual rental fee. Thus, if his cost of capital was 10%, then he would need to make \$10MM on his \$100MM of capital before he would be considered to be making an economic profit. Note that this differs from accounting profitability which does not recognize that the capital has a cost.¹

¹ When we analyze companies we can choose from a variety of different approaches to capital (ROE, ROA, ROCE, CFROI, EV/EBITDA, etc) but the key issue is that we choose a method that is appropriate for a particular industry and second that we use a methodology for computing both the return on capital and the cost of capital that is mutually consistent. In the case of financials we have chosen to use return on equity and cost of equity as our primary value enhancement measure for a couple of reasons, including its simplicity and versatility when comparing lending institutions with non-lenders.

How does one determine a company's cost of equity? The cost of equity is the rate of return that one is going to demand that a manager earn in order to compensate us for the risk that we will take to hold his stock instead of simply buying government bonds (the risk-free alternative). While the most common way to calculate the cost of equity is to use the capital asset pricing model (CAPM), to simplify our calculations we can merely take the risk-free rate (the Canadian government of Canada 10 year bond trades at 3.25%) and add a risk premium. For small cap equities, a reasonable premium would be 4%. Thus, the cost of equity for a typical financial services company would be somewhere close to 7.25%. A company that earns an ROE of 7.25% would therefore be earning a return equal to its cost – from an economic perspective the company is neither earning an economic profit nor making an economic loss even though the company would clearly be making an accounting profit. In this context then, our goal is to identify companies that can earn an ROE that is significantly higher than its cost of equity and for the DKAM fund we are typically looking for companies that can earn an ROE of 20% or better, or roughly 3x their cost of equity.

Why do we care how much a company makes in terms of either an economic or accounting profit? There are three reasons. First, as we have discussed the ROE over a long period of time is analogous to the rate at which our investments will compound. Second, the ROE tells us how well we are performing in relation to the cost of equity, and this tells us how well we are being compensated in relation to both the risk free rate and the riskiness of the investment (which determines the risk premium). The third reason why ROE is important relates to competitive advantage and the persistence of returns.

It's all about the Moat! Economic theorists argue that when a company earns an ROE greater than its cost of equity, the company in question is making an “excess” return. According to the theory, these excess returns eventually attract new entrants who bid away these excess returns until the enterprise's ROE falls to a point that is roughly equal to its cost of equity. This process of mean reversion is not instantaneous but it tends to happen over a few years. However, some companies do not revert to the mean because they possess some kind of competitive advantage that prevents new entrants from bidding away these excess returns. This competitive advantage can come from a variety of factors including customer captivity, proprietary technology, economies of scale, and government protection. Regardless, identifying companies that are protected from competition (we call this the moat) is one of the key attributes of our investment style. The key sign or leading indicator of such a company is often the existence of high ROE.

Good ROE versus Bad ROE. Identifying and investing in companies that have high and sustainable ROEs is our goal at DKAM. Some critics will argue that ROE is too simplistic a metric to hang one's hat on – and while we agree, we still think it's an excellent starting point. The most frequent criticism of ROE is that it fails to address the issues of leverage. Return on equity in its simplest form can be seen as the product of the return on a company's assets and its leverage ($ROE = ROA \times \text{Leverage}$). Thus, a high ROE can be achieved by raising either ROA or leverage, and clearly the former is preferred to the latter. This point can be illustrated in figure 4 below which ranks the 12 public banks and trust companies that are federally regulated lenders. The lenders in figure 4 are ranked by their ROE from highest to lowest, but we also provide a breakdown showing how much of the ROE comes from leverage and how much comes from return on assets (ROA). Ideally, we want to own a company that has both a high ROE and a low degree of leverage. In this context, Home Capital stands out given its superior ROE and low degree of leverage. Besides Home Capital, we view TD, Equitable and Canadian Western Bank as representing attractive trade-offs between risk (leverage) and return (ROE).

Figure 4 - Looking for ROE the DKAM way - ranked by 2007 ROE

Lender	ROA	X	Leverage	equals	ROE	Comment
CIBC	0.97%	x	30.6	equals	29.6%	Like the ROE but too much leverage
Home Capital	2.03%	x	14.1	equals	28.6%	Lowest leverage, second highest ROE - perfect!
Royal Bank	0.95%	x	26.2	equals	24.9%	Like the ROE but too much leverage
Scotia	1.01%	x	23.2	equals	23.4%	Like the ROE but too much leverage
TD	0.98%	x	19.9	equals	19.4%	Good balance between leverage and ROE
Equitable	1.03%	x	17.1	equals	17.7%	Good balance between leverage and ROE
Canadian Western	1.15%	x	15.1	equals	17.3%	Good balance between leverage and ROE
Bank of Montreal	0.61%	x	22.6	equals	13.8%	ROA and ROE is too low
Laurentian	0.54%	x	22.9	equals	12.3%	ROA and ROE is too low
National	0.45%	x	26.7	equals	12.1%	ROA and ROE is too low
Western Financial	2.10%	x	3.1	equals	6.4%	A significant economic (EVA) loss!
Pacific & Western	0.14%	x	21.8	equals	3.1%	A significant economic (EVA) loss!

Source: Annual Reports

Final comments on ROE – In the Berkshire Hathaway annual report for 1979, Warren Buffet wrote “The primary test of managerial economic performance is the achievement of a high earnings rate on equity capital employed (without undue leverage, accounting gimmickry, etc) and not the achievement of consistent gains in earnings per share”. This sentence from Buffett really identifies the central ethos of the DKAM fund which is the identification and ownership of a small collection of exceptionally managed companies that can earn high ROE’s on a sustained basis. At the time of writing, the weighted average ROE of our fund is approximately 35%, and we feel comfortable that the Companies we have invested in will deliver tremendous value in the months and years ahead.

The road less traveled

A salute to Canaccord. The DKAM fund owns a small position in Canaccord Capital, most of which was purchased at prices close to where the stock is trading right now. Many of you who read the business pages of the newspaper will know that Canaccord was at the center of the Asset Backed Commercial Paper (ABCP) debacle which left close to 1400 of its retail clients holding what they thought was high grade investment paper. As it turned out the ABCP wasn’t quite as pristine as anyone thought.

Canaccord does the right thing. Although the ultimate responsibility for the ABCP mess has yet to be determined, and will probably fall on the shoulders of many parties, Canaccord recently announced that it would pay back all of its small retail investors at 100 cents on the dollar. This decision will impact Canaccord’s upcoming quarter, but we view the financial hit as relatively immaterial in the long-term. However, the stature of the Canaccord management, led by its Chairman Peter Brown, has never been higher and this we expect will reinforce Canaccord’s standing in the financial services community for many years to come. Kudos to the people at Canaccord for doing the right thing.

Required reading

Buffettology. Several investors in the DKAM fund have requested that I provide a reading list of books or articles that can help them understand the investment process that we use at DKAM. In my view, one of the best investment books that I have read is **Buffettology** by Mary Buffett and David Clark. While there are a gazillion books written about Buffett, most are not as valuable as reading Buffett's writings in the original. However, what I like about Buffettology is that it clearly breaks down the salient aspects of Buffett's investment philosophy into manageable and easily understood segments. This book is a light read yet if you understand what it has to say about investing it the DKAM newsletter will be much more easily understood. The book is available in paperback for around \$18.00 and can be found at any Chapters or book store with a large business section.

Closing thoughts

Recovery signs ahead. The fund closed its first quarter, down 1.6%. Since the end of the quarter, financials have rallied and the fund's NAV is slightly in the black. We continue to focus on building positions in Canada's best managed financial services companies at attractive prices. As such, while we have been in a high cash position for much of the past quarter, we are now moving more steadily into the market, with our current cash position now at 35% versus our long position at 65%. All ten of the stocks we hold in the fund pay dividends or distributions and we do not generally short the market or stocks and have no short positions at present. Call if you want to chat – 416-364-8886.

J.P. Donville - DKAM

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