

## Once every twenty years.....

It would be somewhat of an understatement to say that 2008 has been a challenging time for investors. As I sit down to write my third newsletter it is clear that the world is attempting to work through the challenges of the sub-prime crisis, record oil prices and what increasingly looks like a significant global economic slowdown. The result has been a sharp drop in equity markets throughout the world with financial services stocks leading the decline. To put this into a Canadian context, the Canadian Banking sector, a proxy for the financial services industry, has had its worst 12 month period of performance (last July to this July) in the past 20 years – and “our” financial services sector has been the best performer within the OECD!

There is nothing pleasant about a falling stock market – they are nasty, frustrating, humiliating, and tiring – but after all that, there are grounds for optimism. James O’Shaughnessy, one of the most insightful thinkers on Wall Street points out that “the only way for long-term investors to really suffer...is to turn a temporary loss into a permanent one by reacting emotionally and selling”. O’Shaughnessy, who is a student of Wall Street’s long-term investment returns, points out that severe market downturns (a drop of 15% or more over a period of five months) are typically followed by a sharp bounce in the market. Thus, the panic seller suffers the dual injustices of both the initial sell-off, and secondly, the missed opportunity to recover with the market.

O’Shaughnessy is not a financial services analyst – he is a quantitatively oriented asset manager. He is also very bullish on financial services stocks in the US. In his July 2008 newsletter, O’Shaughnessy points out that the S&P Financials index is down 43.5% from a year ago making the current bear market in financials the second most severe in the last 50 years. Notwithstanding the severity of the downturn, the author points out that “financial downturns are a normal occurrence throughout the past 44 years”, noting that the US has seen 6 sharp sell-offs in the financial services sector since 1964. O’Shaughnessy goes on to show that the average one year bounce following one of these steep sell-offs is in excess of 30% and that the three year compounded return following one of these sell-offs has been close to 20% per annum over three years. These are significant returns for a large – cap portfolio.

**Figure 1 - US Large Cap Financials  
Worst Rolling 1 - Year Returns (%)**

<b>Rank</b>	<b>Period Ending</b>	<b>12 month Return</b>	<b>Subsequent 1 Year Return</b>	<b>Subsequent 3 Year Return*</b>
1	Sep-74	-50.0%	30.1%	20.7%
2	Aug-74	-44.0%	35.0%	19.7%
3	Jul-74	-38.1%	27.8%	15.3%
4	Oct-74	-35.6%	8.5%	9.7%
5	Oct-90	-34.3%	60.7%	32.3%
6	Sep-90	-33.3%	48.7%	30.8%
7	Jun-08	-31.1%	?	?
8	Dec-74	-29.0%	13.8%	11.5%
9	Nov-74	-28.5%	15.8%	12.2%
10	Nov-90	-25.8%	33.7%	25.0%
<b>Ave</b>		<b>-35.0%</b>	<b>30.40%</b>	<b>19.7%</b>

Source: O'Shaughnessy Asset Management - July 2008 Newsletter

\*Compounded return

Our analysis of the Canadian banking sector shows similar numbers (although our data does not go back quite as far as O'Shaughnessy). Since 1988, Canada has seen three sharp sell-offs in the Canadian banking sector. The first occurred in 1990 as a result of several factors including a severe recession, aggressive real-estate lending and ill-advised loans to developing countries. The second occurred in the late 1990's and was precipitated more by the cessation of potential merger talks within the banking industry than economic factors, while the third major sell-off is occurring now. Our analysis shows a similar pattern to the US data with sharp rebounds in price occurring in both a one-year and three-year context – see figure 2 below.

**Figure 2 - Canadian Banks  
Worst Rolling 1- Year Returns (%)**

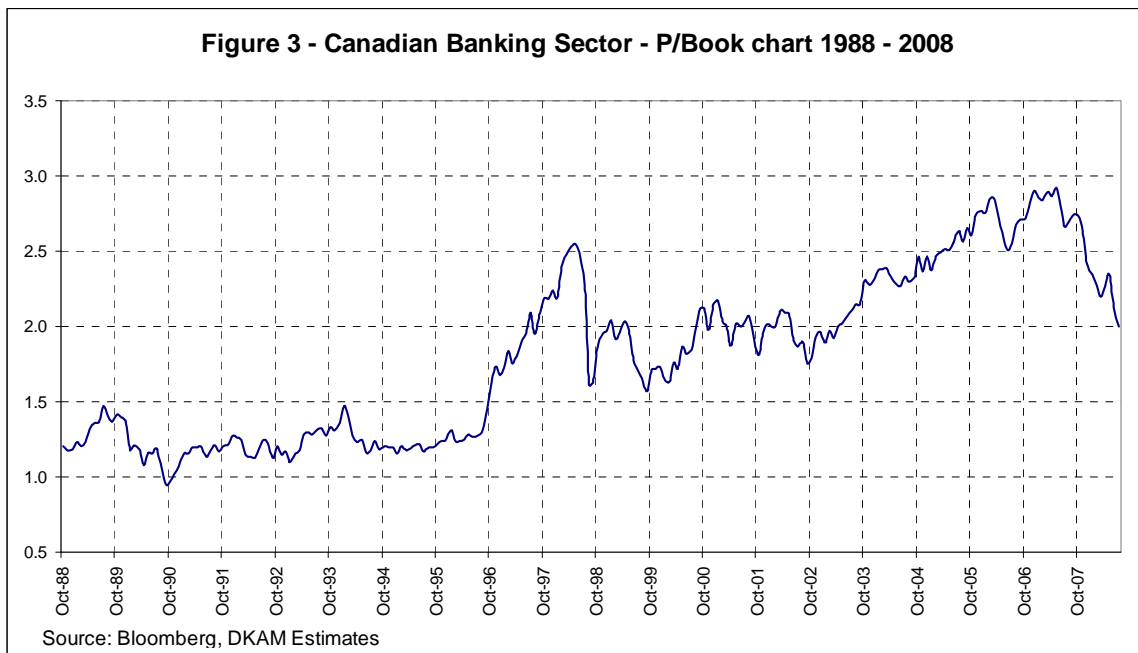
<b>Rank</b>	<b>Period Ending</b>	<b>12 month Return</b>	<b>Subsequent 1 Year Return</b>	<b>Subsequent 3 Year Return*</b>
1	Jul-08	-27.2%	?	?
2	Oct-90	-24.7%	42.2%	20.8%
3	Sep-90	-23.9%	43.2%	19.4%
4	Jun-08	-21.0%	?	?
5	Nov-90	-20.0%	37.0%	17.6%
6	Jun-99	-20.0%	13.0%	12.0%
7	Mar-08	-19.1%	?	?
8	Aug-90	-18.0%	31.8%	16.7%
9	May-99	-15.6%	6.4%	12.3%
10	Jul-99	-15.4%	17.8%	11.9%
<b>Ave</b>		<b>-20.5%</b>	<b>27.30%</b>	<b>15.8%</b>

Source: DKAM

\*Compounded return, excludes dividends, July return is a mid month data point

It's hard to imagine that anyone could be even mildly positive about the financials given their recent performance. However, besides O'Shaughnessy, there are others that at least appear to be cautiously optimistic about the sector. The Bank Credit Analyst (BCA) in its most recent weekly bulletin points out that the huge bet of this decade has been "go long resources and industrials, sell banks and financials". However, in their view, "it does not take a genius to see that this massive trade is at a very late stage." BCA goes on to point out that while "it is impossible to precisely time the end to this gigantic trade....make no mistake: The trade of the decade will be reversed and when that happens there will be an equally gigantic switch among investors." BCA also points out that the relative valuations of the US banking industry are now 20% lower than during the S&L crisis in the early 1990's, which was the last great opportunity for investors to buy the financials. BCA uses a P/Book methodology to make its case while O'Shaughnessy makes a similar point in his July newsletter using P/Sales metrics.

In Canada, the valuation picture is also attractive although not quite as extreme as in the US. In figure 3 we see that the P/Book multiple for the banking sector has fallen to 1.8x, which is at the lower end of where it has traded over the past decade, but still high in relation to where it traded in the early 1990's. This has led some pundits to respond that the financials still have a great deal to fall. However, a simple P/Book, P/Earnings or P/Sales chart can be misleading, particularly given the change in interest rates and returns on equity that have occurred in the banking sector over the past 30 years.



Those who argue that the banking industry will or should trade at a lower p/book multiple (such as it did in the early 1990's) fail to consider the following. In the early 1990's the risk free rate (GCAN 10 Year Bond) had a yield of 9-10%, while the banking sector's ROE at that time dipped to as low as 4%. Currently, the projected ROE for the banking sector for 2008 and 2009 is around 14% while the risk free rate currently stands at 3.7%. Thus, in 1990-1992, the banks were earning a return that was less than half the risk free rate while today, and even after taking into account significant write-downs, they are still expected to earn a return on equity that is almost 4 times higher than the risk free rate. Thus, investors who

expect that the sector will trade lower in P/Book terms are asserting that either a huge jump in interest rates and/or a massive drop in bank earnings will occur from current levels.

Indeed, as of the middle of July, our model suggests that the Canadian banking sector is 35% undervalued. Of course, our model is dependent on a couple of key variables which we have already touched upon but are worth explaining further. First, our model assumes that the banking sector's ROE will trough in 2009 at 13.8%, which we believe is conservative. However, it is worth noting that the market's current valuation implies that the industry's 2009 ROE will come in at something closer to 8.9%. This therefore suggests that 2009 consensus earnings are still dramatically too high – which we simply do not agree with. The other key variable is the risk-free rate. At the time of writing, the 10 year Government of Canada rate is 3.7%, whereas the current p/book multiple suggests an implied risk free rate of 6.5%. Given the slowdown that is occurring in the global economy (which ultimately becomes deflationary) we doubt that interest rates are heading much higher. Therefore, we do not see a lot of downside in the Canadian banks from current levels.

### **The DKAM Financial Services Venture Fund LP**

The fund was up slightly in Q2/08. For the year, the fund is down 1.48% which compares to the TSX S&P Capped Financial Services Index that dropped 13.8% in the first half of the year. Q3/08 is off to an incredibly volatile start with the financials getting pummeled in the first two weeks of the month only to begin to stage a rally as we put this newsletter to print. Such volatility is often symptomatic with a change in market leadership and thus BCA's call for a reversal out of the resource and energy stocks into the financials might possibly be at hand.

Regardless of the short-term volatility of the market, we continue to build large positions in high quality, under levered financial services stocks that are trading at deep discounts to their intrinsic value. We are currently 90% invested and expect to be 100% long or longer by the end of Q3/08. We believe that the vast majority of the Canadian Financial Services industry is in good shape and believe that mangers such as Gerry Soloway, Larry Pollock, Rick Skauge, Andrew Moor, Ira Gluskin, Kevin Reed, Paul Smith, Doug MacIntyre and Mark Warren will continue to avoid the slings and arrows of a tough market through prudence and entrepreneurial zeal.

Call me if you want to chat – 416-364-8886  
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