

Even In The Eye Of The Storm It Can Get Pretty Windy

It's pretty ugly out there. Financial services companies continue to get rocked on a daily basis and newspapers try to out "gloom and doom" each other with increasingly sensational headlines. Overseas markets we are told are similarly imperiled as problems emerge in countries ranging from Russia to Pakistan. No global blue-chip is immune from the hysteria, no market is safe. So what is an investor to make of this?

First of all, if you are a Canadian investor, you need to know that for a variety of reasons, our financial services industry is in better shape today than almost any other financial services industry in the world. Canada's major banks, insurance companies, mortgage lenders and bourses are extremely well capitalized – I cannot think of a single exception to this statement. Even the current bad-boys of Canadian Finance, including CIBC, BMO, Sun Life and Dundee have balance sheets and financial models that would make them the envy of mainstream financial services executives in any other country.

So why is our financial services industry so strong? Two factors stand out. First, our regulatory framework is conservative and risk averse. The impact of this high regulatory ceiling is that while it limits competition in good times it also leads to financially stronger entities which we certainly appreciate in bad times. Second, the Canadian mortgage lending industry never ventured into the sub-prime lending mania to the extent that became so mainstream in many countries including the US and UK over the past five years. This is not to say that we were smarter than the likes of Countrywide or Washington Mutual – we were just much slower to react to the opportunities available in sub-prime and thus never had a chance to ramp up like lenders in other countries. Regardless, our banks and mortgage lenders are neither stuck with massive amounts of insolvent mortgages nor addicted to the fees that were generated by the financial engineering mania.

So what should an investor do? The simple answer is "sharpen your pencil and stay engaged". Market bottoms typically occur when despair is everywhere, headlines in newspapers are bleak, volatility is high and valuations are at extremes. That describes the market we are in today and our belief is that the more severe the market downturn, the more significant the

market bounce. Indeed, the key imperative at this stage of the market is to ascertain which companies are best positioned for the inevitable business cycle and stock market recovery. Companies with strong balance sheets and high returns on equity are the ones we are focusing on – we don't even have to look for reasonable valuations as value is everywhere.

In the face of the demise of Lehman Brothers, the sale of Merrill Lynch to Bank of America and the US Government's takeover of AIG, our optimism perhaps seems unwarranted. However, it is worth noting that economies and markets do follow cycles and there are particular times in any asset cycle where counter-intuitive thinking must come to the fore. Such thinking is encapsulated in sayings that include "be fearful when others are greedy and greedy when others are fearful"¹ or "buy when the blood is running in the streets"². Our view is that the financial crisis in the US is nearing a climax although we acknowledge that the final stage in any crisis is often the most painful as it involves capitulation in a very broad sense. As such, we suggest that investors should now be positioning their portfolios for the growth stages of the economy that inevitably occur after every economic downturn. We remain particularly positive on financial services stocks as they have historically lead economic recoveries and because many key valuation metrics in the financial services industry have fallen to multi-decade lows.

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Cycles Within Cycles

The economy and stock market tend to run on relatively consistent (but not necessarily predictable) cycles. Historically, spikes in volatility tend to mark the end of the growth phase of a cycle and the beginning of another. According to the US based National Bureau of Economic Research (NBER), the average growth phase of the US economy (since the end of WWII) has been 59 months (roughly five years) while the average recession phase has lasted 10 months. My sense is that the numbers for the Canadian economy are roughly similar given the inter linkages between the two economies. Thus, on average we tend to experience five good years in the stock market and/or the economy for every bad one.

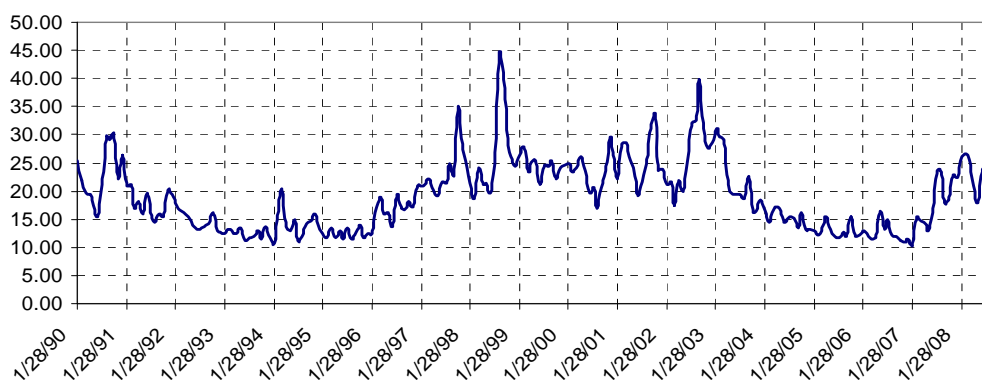
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Spikes in volatility during the one bad year in six are in my view a tangible sign of investors repositioning their assets out of one asset class or segment of the economy into another. This can involve a movement from equities into cash and back again, as well as movements within a specific asset class such as shifts in weightings from long-term bonds to short-term bonds. Regardless, this process can be very dynamic (volatile) as evidenced by the movement of capital away from real estate assets in the early 1990's, into technology assets in 1999 and out again in 2001-2003 and the recent movement in and out of commodity stocks (2008).

¹ Widely attributed to Warren Buffett

² Widely attributed to Nathan Rothschild

Figure 1 - CBOE Volatility Index - Month End 1990 - 2008



Source : CBOE

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While many of us do not like volatility (and the changes that it implies), what is important to note is that a sustained period of volatility in the stock market is normally the precursor to the next growth phase of the economy. And while it is difficult to say exactly where we are in the cycle, the fact that we have been in a prolonged period of volatility suggests that the end of this bad patch is near. For those looking for a more specific timetable, the highly regarded Bank Credit Analyst (BCA) has recently asserted its belief that the current downturn is 80% complete, which suggests that an upturn in the markets is perhaps only a month or two away. This view would be consistent with the perspective of many market strategists who have argued that the market needs a final cathartic event before it finds its bottom. Given that the demise of Lehman, the sale of Merrill Lynch and the nationalization of AIG all occurred over the same week, we can consider this a single event and possibly the cathartic event the market needs to find its bottom. This will only be clear in time.

Opportunity Knocks

From an investor's perspective, the current period of extreme volatility is an important time in the economy and stock market for three key reasons. First, valuations typically bottom during moments of extreme market volatility – and we believe that Canadian financial services stocks (using the banks as a proxy for the broader financial services industry) are at 20 year lows when viewed on an adjusted basis. Second, certain stocks tend to perform better at different times within the cycle – and based on history we should expect the financials to perform well immediately upon our exit from this tumultuous period. Finally, the companies and industries that will lead the next five year cycle will typically begin to establish their leadership now. The next turning point in the cycle is therefore an extremely important time for investors.

Financial Services Stocks in Canada and Elsewhere Are Cheap

At market peaks and troughs, earnings based valuations can be quite misleading as the cyclicality of earnings makes many stocks appear cheap at the top of the cycle and expensive at the bottom of the cycle. As such, analysts and investors will tend to use more stable valuation metrics such as P/Book, P/Sales and dividend yield to gain a better sense of how expensive or cheap a particular sector of the economy is. In the case of financial services, P/Book and dividend yield are the two most common ways to assess the valuation of the market at peaks and troughs, although even with these two metrics, a certain amount of interpretation is required. The long-term p/book chart for the Canadian Banking industry is presented below.

Figure 2 - Canadian Banking Sector - P/Book chart 1988 - 2008



Source: Bloomberg, DKAM

THE SUSTAINED EXPANSION IN ROE THAT HAS OCCURRED IN THE CANADIAN BANKING INDUSTRY OVER THE PAST 20 YEARS HAS OCCURRED LARGELY BECAUSE OF A SHIFT IN THE BUSINESS OF THE MAJOR BANKS.

Figure 2 above shows that the Canadian Banking industry is reasonably priced in P/Book terms in relation to the past decade but not in relation to the past twenty years. However, what this P/Book chart does not reflect is two changing dynamics in the banking industry over the past 20 years. The first has been the expansion in ROE of all of the major Canadian banks due to a change in their business mix. The second factor has been the gradual drop in interest rates over the same time frame – and both of these issues deserve separate comments.

The sustained expansion in ROE that has occurred in the Canadian banking industry over the past 20 years has occurred largely because of a shift in the business of the major banks. In the early 1990s, the typical Canadian bank was heavily focused on commercial lending and had relatively small asset management and investment banking franchises. However, all Canadian banks have made significant investments in both asset management and investment banking and these investments continue in 2008 (RBC's acquisition of PH&N is a case in point). Notwithstanding this shift in asset mix,

most Canadian Banks have also engaged in off-balance sheet activities which, to some degree, added leverage to their balance sheets and therefore boosted ROE. This has led many analysts to conclude that the banks will have lower ROE on a go forward basis. Our sense is that ROE will remain high as the deleveraging effect will be offset by ongoing investments in asset management. This suggests that valuation measures dating back more than a decade are relatively meaningless in large part because they no longer represent an exact comparison of similar banking franchises.

Figure 3 - Canadian Banks Relative ROE Supports Share Price Performance

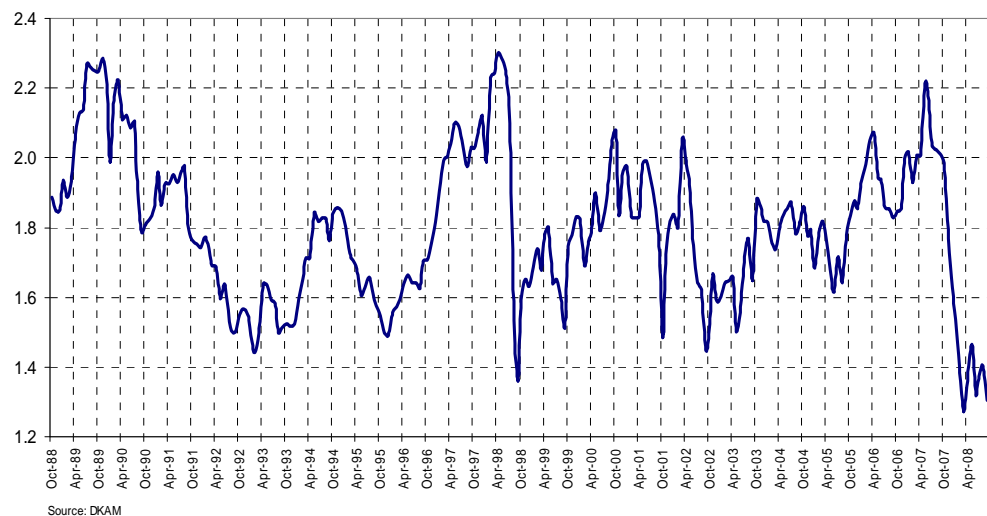
	1970's	1980's	1990's	2000-2007
S&P/TSX Bank Index	7.7%	4.1%	11.3%	15.8%
S&P/TSX Composite Index	4.6%	3.4%	4.9%	10.5%

Source: Fame, as quoted in BMO Capital Markets Research, September 2008

The second factor that obscures the relative attractiveness of the banking sector is the dramatic lowering of the risk free rate over the past decade. If one looks at valuations in the early 1990's, the banking sector experienced trough ROE in the 4-8% range while the risk-free rate (10 year Government of Canada) stood at 9-11%. Thus, the ratio of ROE to the risk free rate was something close to 0.5x and therefore it is no wonder that banks traded at less than book value. Today, trough ROE are in the 12-20% range while the risk-free rate stands at 3.9%. Thus, the ratio of ROE to the risk free rate stands at something close to 4.0x. In figure 4, we present the same p/book data that appears above in figure 2 re-balanced for the changes in the risk free rate between 1988 and 2008. In this context, the Canadian banking industry appears cheaper today in adjusted p/book terms than it has at any point in the past twenty years. It is indeed our sense that the Canadian Financial services industry is lining up for a significant upward move (+35-50%) over the next 12 months, a move that would simply bring it back to its median long-term valuation.

OUR SENSE IS THAT ROE WILL REMAIN HIGH AS THE DELEVERAGING EFFECT WILL BE OFFSET BY ONGOING INVESTMENTS IN ASSET MANAGEMENT.

Figure 4 - Canadian Banking Sector - Adjusted P/Book Multiple 1988-2008



Source: DKAM

Our Optimism is Consistent with Business Cycle Analysis

Figure 4 should be an exciting one for investors because it shows that the valuation precursor for a rebound in Canadian banking stocks is in place. However, there is a second reason why investors in financial services stocks should be positive. Investors have known for years that certain industries tend to perform well at different stages in the economic cycle and financials are no exception. As mentioned earlier, the NBER breaks the business cycle into five distinct stages with stages I, II, and III being expansionary and lasting on average 20 months in duration. The two recessionary stages (IV and V) last on average 5 months each. In each of these five stages, different industries tend to outperform and in some cases they do so dramatically. Figure 5 shows which industries perform best in each stage of the economic cycle with financials performing best in stage V. Thus, financials perform best before a recovery is even in view.

Figure 5 - Stages of the business cycle where sectors are expected to provide relative out performance

Stage I	Three Stages of Expansion			Two Stages of Recession	
	Stage II	Stage III	Stage IV	Stage V	
Technology	Basic Materials	Consumer Staples	Utilities	Financials	
Computer Software	Precious Metals	Agriculture	Gas & Electrical	Banking	
Measuring & Control Equip.	Chemicals	Beer & Liquor	Telecom	Insurance	
Computers	Steel Works	Candy & Soda		Real Estate	
Electronics Equipment	Non-Metallic & Metal Mining	Food Products		Trading	
Transportation	Capital goods	Healthcare		Consumer Cyclical's	
General Transportation	Fabricated Products	Medical Equipment		Apparel	
Shipping Containers	Defence	Pharmaceutical Products		Automobiles & Trucks	
	Machinery	Tobacco Products		Business Supplies	
	Ships & Railroad Equipment	Energy		Construction	
	Aircraft	Coal		Construction Materials	
	Electrical Equipment	Petroleum & Natural Gas		Consumer Goods	
	Services			Entertainment	
	Business Services			Printing & Publishing	
	Personal Services			Recreation	
				Restaurants	
				Retail	
				Rubber & Plastic	
				Textiles	
				Wholesale	

Source: *Sector Rotation over Business Cycles*, Stangl, Jacobsen, Visaltanachoti, Massey University, Department of Commerce, 2007

...FINANCIAL SERVICES STOCKS TEND TO PERFORM BEST IN STAGE V BY A CONSIDERABLE MARGIN (UP 37 – 46%)

How well do the financials perform in stage V? According to Stangl, Jacobsen and Visaltanachoti³, who studied four segments of the financial services industry in the US (namely banking, insurance, trading and real estate), financial services stocks tend to perform the best in Stage V by a considerable margin (up 37-46%). The US Banking sector for example, which has historically earned a return of 8.8% over the entire cycle, earned an annualized return of 41.3% during all stage V between 1948 and 2006. Thus, the rewards for investors if they can capture these returns are significant, even if the investor turns out to be early. Of course, figure 5 makes investing seem easy and it is not. The three authors of the study cited above noted that it was just about impossible to outperform the market by jumping from sector to sector. That said, we think the framework is useful because it highlights the

³ Sector Rotation over Business-Cycles, Stangl, Jacobsen, and Visaltanachoti, Massey University, Department of Commerce, Auckland New Zealand.

potential upside available to investors who invest in financials after a major correction occurs.

The Quest to Find the Next Home Capital is On

The paper by Stangl, Jacobsen and Visaltanachoti is also consistent with other research we have highlighted in earlier editions of the DKAM ROE Reporter, namely that the best returns often involve companies or industries emerging from a significant downturn. Notwithstanding the recent correction in the price of commodities, the real money in oil, potash, corn, gold, uranium, was made 5-6 years ago by those investors who were prescient or lucky enough to buy large stakes in companies that would be beneficiaries of the commodity boom. Indeed, the same comment could be made about the investors who were buying technology stocks in 1994 (and selling them in 1999). For an investor in the Canadian financial services industry, the period between 2002 and 2007 was a very positive one, but the truly big returns were achieved by those investors who saw the emergence of companies like Home Capital, the TSX Group, and Canadian Western Bank before they became market darlings.

Comments

The credit crisis in Canada and the US is now more than a year old which makes it long in the tooth by historic standards. Further, with volatility spiking, it suggests that we may be in the late stages of the crisis. Finally, valuations are now at extremes. As of the middle of September, the DKAM Financial Services Fund is down roughly 9% year to date, versus the TSX which is also down 9% and the S&P TSX capped financial index which is down 14% year to date. The fund is now 100% invested (but not levered) and although we are not market timers, our sense is that better times are ahead.

These are tumultuous times. – call if you want to chat – 416-364-8886

Jason Donville

Jason Donville – President and CEO - DKAM

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