

We are in the Buffett Camp

While this has been the worst year in the history of global stock markets, the DKAM Financial Services Fund has performed better than the market and all other funds that invested strictly in financial services in Canada in 2008¹. YTD, the DKAM Financial Services Fund is down 26.4% versus the market which is down 33.6% over the same time frame². The bulk of the fund is invested in high quality, financially strong companies which include Home Capital, Olympia Financial, the TMX Group, The Equitable Group, and Bank of Nova Scotia – and we expect all of these companies to report solid if not strong quarterly results in the coming days. Valuations, as you have heard *ad nauseum*, are at multi-decade lows and this suggests that when a rally in the market occurs it will be significant.

This point can best be illustrated by looking at an example. The Equitable Group is a federally regulated trust company that is today valued at 0.7x book value per share and trades on 4.8x 2008 consensus earnings. Thus, if Equitable's stock price simply reverts to its book value per share, this would imply a return of 33%. Prior to 2008, Equitable traded on a P/E multiple of 11.0x, and if it were to return to this multiple over the next 12 months, the stock would therefore rise to a valuation of \$31.90 (\$2.90 in earnings x 11). This means the stock could rise 227% if it simply returns to the forward P/E multiple that it has traded at over the previous five years. No this is not a typo (or a prediction) – it is simply an attempt to quantify and make tangible the degree of valuation distortion that has occurred in equity markets around the world including Canada in 2008.

While investors should be disappointed in the performance of stocks this year, the opportunity for these losses to be recouped quickly is feasible given the valuation picture. While economic risks remain significant throughout the world, we believe that the bulk of the sell-off in the market since the middle of September is non-fundamental. By that we mean that we believe that most sellers are forced-sellers who are liquidating positions for a variety of reasons. This has led to an overshoot on the valuation front which has taken the share prices of most companies well below any sense of fair (or intrinsic) value. Such extreme valuations have led none other than Warren Buffett to write, for only the third time in his life, that NOW is the time to own stocks³. However, before we start talking about the future and a recovery in the stock market, let's go back and take a brief look at the events of the past year and the past six weeks in particular.

810 – 36 KING STREET E
TORONTO, ON M5C 1E5
T 416 364 8885
F 416 364 5999

DONVILLEKENT.COM

¹ Globefund / Morningstar

² Based on Closing Prices on October 24th, 2008

³ See Appendix 1 at the back of this report for Warren Buffett's Op-ed piece from the NY Times

Liquidation World

Throughout 2008 we have viewed the economy and stock market in the context of a more or less typical (garden variety) economic downturn. Under such an economic scenario, the stock market anticipates the downturn in the economy and sells-off with financial services stocks usually taking the lead in a stock market's general downturn. As we have written in earlier editions of the ROE Reporter, such downturns on average last about a year and the strategy of buying the financial services stocks centers around a few key factors. Identifying where we are in any cycle is difficult but the general strategy with respect to the financial services stocks is to buy into the sector once two of the following conditions has been met. First, the sector should have experienced a substantial downturn in terms of share prices and two; the economic downturn should have been in place for at least six months. Thus, with stock prices in the Canadian banking industry having peaked in May of 2007 (17 months ago!), and the banking sector off by more than 20% year over year by Q2/08, it appeared that the middle of 2008 would be an appropriate time to begin to accumulate positions in the market.

Indeed, up until about a month ago, the sensibility of this strategy appeared to be playing out fairly well as the financial services stocks hit their cathartic bottoming event in the middle of July 2008 when the nationalization of Fannie Mae and Freddie Mac in the US seemed to bring an end to a sell-off in the financials. At the same time, oil prices were beginning to fall from their peak of just under \$150 a barrel and thus from the middle of July 2008 until the middle of September 2008, the financial services stocks in both Canada and the US outperformed the market quite handily (as they typically have done in the latter stages of most economic downturns and/or recessions). And then, sometime around the 15th of September it all started to unravel!

In a few years from now economists and historians will more thoroughly document the saga of 2008, but the quick and dirty post-mortem that is now emerging is that the failure of Lehman Brothers was a far more important event than many people realized at the time. Until the demise of Lehman, the US Government had shown itself prepared to either facilitate and/or rescue any large financial institution on the verge of failure, as it had done earlier in the year with Bear Sterns, Fannie Mae, Freddie Mac and several smaller regional banks operating under the auspices of the FDIC. However, with anger looming from "Main Street USA" about the scale and degree of government assistance and an election only a few months away, a decision was made at some level to allow Lehman to fail. Unfortunately, this set off a financial Tsunami with truly global reverberations.

The failure of Lehman crystallized the reality that saving a large and important institution might be beyond either the means or political will of a nation such as the US. The reasoning of the market was that if Lehman could fail, then no institution could be trusted and no degree of financial assurance could be garnered in the absence of an emphatic backstop from a sovereign entity. This, of course is how all banking crises end – banks to some degree are nationalized and calm is restored to the systems.

Of course, in the intervening period between the collapse of Lehman (September 15th) and the nationalization of many parts of the global financial services industry (roughly the 15th of October) the global economy has slowed dramatically. Indeed, what subsequently transpired was a complete seizure of the global financial system as banks refused to lend to each other, let alone to industry, home owners, and entrepreneurs. Ships sat at the dock (literally) as the mechanisms for global commerce, ranging from letters of credit to working capital loans, were withheld, cancelled or simply ignored.

...FROM THE
MIDDLE OF JULY
2008 UNTIL THE
MIDDLE OF
SEPTEMBER
2008, THE
FINANCIAL
SERVICES
STOCKS IN BOTH
CANADA AND
THE U.S
OUTPERFORMED
THE MARKET
QUITE HANDILY...

Force majeure was everywhere. Thus a credit crisis mushroomed into a full fledged economic downturn that reached into virtually every corner of the global economy.

...OCCURRING IN PARALLEL WITH THE COLLAPSE OF THE GLOBAL BANKING SYSTEM WAS THE MASSIVE RUSH TO THE EXITS BY INVESTORS IN EVERYTHING FROM HEDGE FUNDS TO MONEY MARKETS.

Occurring in parallel with the collapse of the global banking system was the massive rush to the exits by investors in everything from hedge funds to money markets. Thus, at the same time that investors would have been selling stocks anyway (as they are wont to do during the early stages of a recession) they were now joined by financial institutions trying to de-lever and hedge funds in liquidation mode. In our view, the forced selling has now over-taken all other issues as the impact of a severe global slowdown and strains within the global banking system are now fully priced in. At a certain point, selling begets selling and only time itself brings this to an end.

Where to from here?

The market is in the midst of a severe tug of war with one side the decisive winner thus far. Against a background of grim economic news are two large and unpredictable camps. In one camp are the forced sellers, those investors and institutions that need to sell and sell quickly and have been pounding stocks lower for months. On the other front are the fundamentalists who believe that stock prices have already discounted an Armageddon like slowdown in 2009. Our sense is that a tug of war between these two camps will continue until year end but that the bulk of the forced selling will have occurred by then. Does this mean the markets go higher in the meantime? This is difficult to say as it is almost impossible to quantify how much selling has already occurred and how much is yet to come but we believe that the preconditions for a bottom in the stock market is in place.

As for our conviction that this bear market will soon end, may I direct you to a book written last year by a good friend of mine, Russell Napier, which is available everywhere and titled *Anatomy of a Bear*⁴. Napier and I worked at CLSA in Asia in the 1990's and he is widely regarded as one of the smartest strategists in the world, a point that I would concur with. In *Anatomy of a Bear*, Napier conducted an analysis of the four most severe bear markets during the 20th century and his conclusion is that bear markets ultimately come to an end when stocks begin to trade below replacement value (Tobin's Q). In Napier's analysis, replacement value is not book value but rather true replacement value. In the US, a market that has been far harder hit than Canada, most stocks in the financial services industry are trading below both book value (which you might argue that they should) but also replacement value. In Canada, there are also many examples of stocks trading below replacement value. For example, if you wanted to own and operate a trust company, it would be far cheaper to buy The Equitable Trust Company (whether you value it at book or replacement value) than to start from scratch. This is because you need to add all of the start up costs associated with a new business and thus the true replacement value is often much higher than the book value.

...BEAR MARKETS ULTIMATELY COME TO AN END WHEN STOCKS BEGIN TO TRADE BELOW REPLACEMENT VALUE.

During the 1990's I saw similar phenomena in Indonesia towards the bottom of the Asian economic crisis (1997-1999). At that time I was working in Jakarta and had a chance to watch companies like the Tata Group attempt to buy entire steel mills and cement plants in Indonesia and physically remove them from Java to South India. Yes, there are times (like now) when assets in the stock market trade well below their true replacement value and as the market begins to digest this reality, bottoms begin to form. We are at this point today in many, many markets.

⁴ *Anatomy of the Bear: Lessons From Wall Street's Four Great Bottoms*, Russell Napier, Harmon House, 2007

Final Comments

The degree of deleveraging that has occurred over the past 30 days has caught everyone off guard. This has resulted in the indiscriminate sell-off of assets throughout the world ranging in nature from stocks to currencies. However, once the panic comes to an end, fundamentals will reassert themselves quickly and the valuations of assets will bounce back quickly. We think and expect that the forced selling that is occurring in today's markets will end soon and that the bounce back in the market will come fast and furious. Although we hedged the fund to some degree at the end of September, we are now 100% invested and unhedged as we enter the last week of October.

These are difficult markets but better times are not far away – call me if you want to chat
– *JP Donville 416 – 364 - 8886*



October 17, 2008

OP-ED CONTRIBUTOR

Buy American. I Am.

By **WARREN E. BUFFETT**

Omaha

THE financial world is a mess, both in the United States and abroad. Its problems, moreover, have been leaking into the general economy, and the leaks are now turning into a gusher. In the near term, unemployment will rise, business activity will falter and headlines will continue to be scary.

So ... I’ve been buying American stocks. This is my personal account I’m talking about, in which I previously owned nothing but United States government bonds. (This description leaves aside my Berkshire Hathaway holdings, which are all committed to philanthropy.) If prices keep looking attractive, my non-Berkshire net worth will soon be 100 percent in United States equities.

Why?

A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful. And most certainly, fear is now widespread, gripping even seasoned investors. To be sure, investors are right to be wary of highly leveraged entities or businesses in weak competitive positions. But fears regarding the long-term prosperity of the nation’s many sound companies make no sense. These businesses will indeed suffer earnings hiccups, as they always have. But most major companies will be setting new profit records 5, 10 and 20 years from now.

Let me be clear on one point: I can’t predict the short-term movements of the stock market. I haven’t the faintest idea as to whether stocks will be higher or lower a month — or a year — from now. What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. So if you wait for the robins, spring will be over.

A little history here: During the Depression, the Dow hit its low, 41, on July 8, 1932. Economic conditions, though, kept deteriorating until Franklin D. Roosevelt took

office in March 1933. By that time, the market had already advanced 30 percent. Or think back to the early days of World War II, when things were going badly for the United States in Europe and the Pacific. The market hit bottom in April 1942, well before Allied fortunes turned. Again, in the early 1980s, the time to buy stocks was when inflation raged and the economy was in the tank. In short, bad news is an investor's best friend. It lets you buy a slice of America's future at a marked-down price.

Over the long term, the stock market news will be good. In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497.

You might think it would have been impossible for an investor to lose money during a century marked by such an extraordinary gain. But some investors did. The hapless ones bought stocks only when they felt comfort in doing so and then proceeded to sell when the headlines made them queasy.

Today people who hold cash equivalents feel comfortable. They shouldn't. They have opted for a terrible long-term asset, one that pays virtually nothing and is certain to depreciate in value. Indeed, the policies that government will follow in its efforts to alleviate the current crisis will probably prove inflationary and therefore accelerate declines in the real value of cash accounts.

Equities will almost certainly outperform cash over the next decade, probably by a substantial degree. Those investors who cling now to cash are betting they can efficiently time their move away from it later. In waiting for the comfort of good news, they are ignoring Wayne Gretzky's advice: "I skate to where the puck is going to be, not to where it has been."

I don't like to opine on the stock market, and again I emphasize that I have no idea what the market will do in the short term. Nevertheless, I'll follow the lead of a restaurant that opened in an empty bank building and then advertised: "Put your mouth where your money was." Today my money and my mouth both say equities.

Warren E. Buffett is the chief executive of Berkshire Hathaway, a diversified holding company.