

Say goodbye to 2008 and hello to 2009

2008 has been one of the most cataclysmic years ever for investors in all asset classes ranging from equities to commodities. Most indices around the world fell by more than 40% in 2008 and some markets were down by more than 65%. Canada entered 2008 in much better shape than most other countries, and as such our economy and stock markets have fared slightly better. In 2008, the S&P TSX index was down 35.0% while the average small or mid-cap equity fund in Canada was down 40.6%¹.

Last year we launched two funds. While each of our funds outperformed their respective benchmarks, we are not happy with our performance. The DKAM Financial Services Venture Fund LP was down 37.3% in 2008 versus the S&P TSX Capped Financial Index which was down 38.3% and the average financial services fund in Canada which was down 46.9%.² Our second fund, the DKAM Capital Ideas Fund LP³ was launched in October and was down 6.1% for the year but has managed to outperform the S&P TSX Index handily since its launch.

Our focus remains on outstanding companies

Although we are not top-down (macro) investors, we expect that 2009 will be a good year for investors for several reasons. First, the drop in markets in 2008 has already priced in a lot of the bad news in asset prices globally. Second, a massive amount of fiscal and monetary stimulus is either in the system or on its way and this stimulus is being coordinated on a truly global scale. Third, there is a significant amount of cash on the sidelines which will come back into the market at some time. Finally, valuations in Canada and abroad are at or near record low levels. Thus, we believe that at some point in the not too distant future the market is going to rise and we expect it will do so in a significant way.

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¹ Source: Globefund as quoted in The Globe and Mail, Tuesday January 6th 2009, page B10

² Ibid

³ The DKAM Capital Ideas Fund has an identical investment philosophy as the DKAM Financial Services Venture Fund LP but is able to invest in all sectors of the economy

Our optimism is shared by a good friend (and good investor), Randall Gilberd of Rockridge Partners in Palm Springs, California. Gilberd writes in his January 9th letter to investors, “We don’t require economic nirvana to record substantial gains from here. Two of the ten best years for the stock market in the 20th century were during the Great Depression (1933 & 1935). Another one of the ten best years last century was in 1908, when the market rose 45%. That rise followed the financial panic of 1907 which resulted from bank runs that October which led to numerous failures of Wall Street brokerage firms. That year the stock market fell 50% from its high the previous year. That financial crises spread to states and municipalities and ultimately led to an overhaul of our regulatory and monetary system. Although the economy contracted and unemployment rose through the middle of 1908, the stock market soared as profit seeking capital was lured off the high ground and out from under the mattresses. Could this be a blueprint for 2009? Yes, perhaps it could be!”⁴

That said, expressing optimism about 2009 suggests that we have some ability to predict the short-term direction of markets which of course we do not. Our philosophy has been and will always be to focus on outstanding companies that will grow their earnings in the long-run at a higher rate of compounding than the market as a whole. Investors who are familiar with the life and times of Warren Buffett will note that he patiently stands by his investments even while “Mr Market” is casting a huge amount of doubt on the merits of a particular investment. Whether it is the irrationality of (high) technology stock prices in 2001 or the irrationality of (low) equity prices in the fourth quarter of 2008, Buffett has always had the ability and resolve to look beyond the market’s short term schizophrenia and focus on those factors that drive long-term wealth. While we cannot state with any certainty that 2009 will be a better year for equity investors (although our instincts and most of the data we track tells us that this is so), we can say that we have never before in our investment careers been able to buy growth stocks as inexpensively as we can today.

Preparing for a recovery in confidence

A rebound in markets and asset prices generally will typically be driven by two factors and these are 1) improving levels of market confidence and 2) a rebound in forward earnings. Our expectation is that a rebound in confidence will come first and the rebound on the earnings front will only be apparent well after the market has begun to rebound. To understand how these two factors interplay, lets take a brief look back at 2008 to explain how this sets us up for 2009.

Looking back at 2008, it is now clear that a financial crisis that began in the US ultimately spread to a global crisis which included a massive and sudden deleveraging that affected virtually all investment asset classes. This deleveraging process is analogous to an individual margin call. When one suffers a margin call, one generally needs to raise capital quickly and thus the margin call results in the investor selling those investments that are most liquid. When a margin call occurs on the scale that occurred in 2008 these “forced sellers” literally overwhelm potential buyers and markets fall sharply. At the same time, falling share prices have a psychological effect on the rest of the market because we tend to equate a falling share price with a pending problem with our investment. Thus, if a stock falls sharply in a short period of time, it is rational for us to assume that this drop in share price means the market knows something we don’t, and that negative news is imminent. Thus, massive margin calls have a compounding effect on market psychology and at a certain point selling begets selling.

Market sell-offs do not just affect investor behaviour in isolation of all other participants in the economy. Corporate executives, analysts and consumers are all affected in different ways by rapidly falling asset values. In a market where asset prices are falling sharply, company executives preserve cash and postpone major capital expenditure programs. Analysts are also attune to the signals from the market and when stock prices fall they typically do two things - they cut earnings

⁴ Randall Gilberd, rg@rockridgepartners.com

forecasts for BOTH the short-term (which is rational) and long-term (which is not so rational), and second, they begin to adopt extremely conservative valuation methodologies. Finally, consumers are also affected by falling asset prices as the combined effect of smaller portfolios and gloomy headlines creates a bunker mentality amongst private individuals with the result being sharp curtailment of consumption. All of these effects come into play in a bear market and become hugely exaggerated in the face of a massive, global wide margin call.

The good news for investors is that once the margin call selling has been exhausted, the reverse psychology will at some point kick in and this is what we expect to occur as 2009 moves forward. Under such a scenario, sellers eventually become exhausted, companies begin to slowly invest in the future, analysts become more bullish and individual consumption patterns begin to normalise. This is what we expect will happen sometime in 2009.

So what should investors do in 2009?

There is still a lot a bad news that is working its way through the economy and while we expect that news headlines will remain bleak for at least another 3-4 months, we think investors should start positioning their portfolios for the inevitable rebound that will occur. For 2009, we think investors should focus on four key concepts.

Key concept #1 – Focus on outstanding companies - Outstanding companies should be owned at all phases of the economic cycle. So what is an outstanding company? In our view it remains those companies that can earn a high return on equity (ROE) throughout the business cycle without undue use of leverage. This high ROE implies some kind of competitive advantage that will drive the long-term compounding process that results in superior long-term returns for investors. We will discuss key companies later in this report.

Key concept # 2 – Financials will lead the recovery of both the economy and stock market – Financial services companies are the intermediaries between borrowers and savers within the economy. As such, the financial services industry plays a critical role in moving capital from places where it accumulates to places where it can earn a higher return. When a financial crisis occurs, many financial intermediaries become damaged or outright insolvent and their function within the economy ceases to exist. In any other industry, this would not be as critical to the broader economy as it is in the financial services industry. However, in our modern economy the financial services industry represents the key mechanism by which capital circulates through our economic system, analogous to the way the blood stream is the key mechanism for oxygen to circulate through the body. Thus, for the economy to even function, let alone grow, some entity must play this role. Indeed, we would go on to say that in the absence of such entities, it is folly to assume that any kind of meaningful economic recovery can occur in any other large segment of the economy until such functionality is restored.

As such, as we move into 2009 we expect that some segments of the financial services industry will be among the first to recover, as a pre-condition to a general recovery in the rest of the economy. Following a financial crisis (as opposed to a simple economic downturn) the pathway to a recovery in the financial services industry can occur in one of four ways. First, the intermediaries (banks, insurance companies, etc) are recapitalised by the broader market. Second, small but otherwise solvent players expand to replace the now insolvent larger players. Third, new institutions are created from scratch to fulfill the needs not being met by now insolvent entities. Finally, in the absence of the three pathways to recovery described above, the government can step forward and play the role that the private sector is no longer capable of playing. Currently, we are seeing all four approaches to repairing the financial services industry occur in the US, the UK, and most of Europe,

with the result being that basic functionality within the financial services industries in most Western countries is slowly returning.

The key question for investors, as growth slowly returns to the economy, is where are the opportunities in the financial services industry? In our view, the key opportunities are presented by companies that have two key characteristics. First, the best investment candidates are likely those that made it through 2008 in better shape (according to the balance sheet) than their peers, and are therefore in a position to seize upon opportunities as they present themselves in 2009 and beyond. The second factor is the existence of an entrepreneurial business culture. Why is this so important? Given the carnage that has occurred in the financial services industry over the past 12 -18 months, great opportunities will exist for emerging companies to supplant incumbent financial institutions, but it will require creative business owners to seize those opportunities. We consider the following six financial services companies to be among the strongest and most attractively positioned in Canada for the coming economic recovery that will eventually occur.

1. **Olympia Financial (OLY)** – Is currently our largest position and was so throughout all of 2008. This Calgary based custody bank was one of only two financial services stocks to have an up year in 2008 (the other was Fairfax). Olympia has no debt on its balance sheet, a growing pile of cash and enjoyed an estimated ROE of 48% in 2008. The Company raised its dividend twice in 2008 with the most recent raise occurring in November by 50%! Olympia is currently a provincially regulated trust company but we expect it will receive its Federal Charter in early 2009. The dividend yield on Olympia currently stands at 5.3% and its dividend has risen faster than any other Canadian financial services company over the past three years.
2. **The TMX Group (X)** – The TMX Group remains among the best managed and protected bourses in the world. The company should be viewed as a toll booth on the economic activity of Canada with substantial competitive advantages in most of its key areas of operation (listings, derivatives, natural gas trading, market data, etc). If you believe that the Canadian economy is anywhere near a trough, then the TMX is a great way to play a broad recovery in the Canadian economy. In addition to its tremendous growth prospects, the TMX group also sports a dividend yield of 5.2% which is in line with many banks that have much riskier balance sheets. We estimate the TMX Group ROE in 2008 was 37.5%.
3. **Fairfax Financial (FFH)** – Of the top 100 Property and Casualty (P&C) companies in the world, probably at least 95 have balance sheets that are loaded with toxic commercial paper assets (ABCP). The only exception that we can think of is Fairfax. As such, Fairfax enters 2009 with one of the strongest balance sheets of any P&C company in the world. However, because the rest of the industry is hurting so badly, pricing is almost certain to rise sharply in 2009 and 2010. In addition to its strong balance sheet, Prem Watsa remains the guru behind its investment portfolio – and investors should note that Watsa's investment returns over the past 20 years have been nothing short of superb. We estimate that Fairfax earned an ROE of 29.1% in 2008.
4. **Home Capital (HCG)** – While Home Capital's share price fell by close to 50% in 2008, it is worth pointing out that its profits rose by more than 20%. In addition, Home Capital achieved this result with the least levered balance sheet among Canada's banks and lending trust companies. This low degree of leverage positions Home Capital extremely well for growth opportunities that we expect will arise later in 2009. We continue to view Home Capital as one of the best managed financial services companies in Canada. We estimate that Home Capital achieved an ROE of 27.4% in 2008.
5. **Gluskin Sheff (GS) and Sprott (SII)** – Asset management companies tend to rise twice as fast as the market in up years and fall twice as fast as the market in down years. Looking

ahead, we expect both Gluskin and Sprott to be at the leading edge of those investment opportunities that will occur in 2009. We estimate that Gluskin Sheff's ROE was 58.7% in 2008 while Sprott's was 40.8% - and those are the ROE's coming off a very tough year which we think has a very low probability of being repeated.

Key concept #3 – Infrastructure stocks continue to offer a terrific risk/reward trade-off – The idea that infrastructure spending will rise sharply in the coming years is not a novel one – but that does not mean that it's not still a good idea. The need to reinvest in infrastructure in Canada and throughout the world is a theme that has been building for many years. However, the current economic slowdown has provided the catalyst which will see massive fiscal stimulus applied in countries ranging from China to Latvia and including, of course, Canada.

Fortunately for Canadian investors, the TSX is loaded with excellent infrastructure companies that include engineering services companies, construction companies, hardware sellers and a variety of tangential industries. Our Capital Ideas fund owns Stantec (STN) and Genivar (GNV.UN), both of which are engineering services companies with outstanding track records and prospects.

Key concept #4 – High yielding stocks look extremely attractive – If one looks across the Canadian investment landscape we see that dividend and distribution yields are extremely high, as is the case with lower quality bonds. These high yields are found in a number of different places but tend to center in two areas, namely financial services stocks and income trusts. While both of these sectors have traditionally been the home of high yields, these yields have reached extremely attractive levels. In some cases, these extreme yields represent an expectation of future dividend/distribution cuts. However, in other cases the market has simply thrown out the baby with the bathwater. High yield plays that we like, among common stock companies, include CIBC (6.5%), Husky Energy (6.2%) Great West Life (5.7%) Olympia Financial (5.3%) TD Bank (5.2%) and TMX Group (5.1%) Among our favourite income trusts are Parkland Industries (17.8%), Direct Cash (16.7%), First National (15.8%) and Freehold Royalty (13.4%).

Stocks are anticipatory in nature

There is no doubt that the global economic picture looks ugly. Q4/08 numbers have not yet been reported and they will be bad, as will Q1/09 numbers as the bulk of the fiscal stimulus that is being discussed has yet to be employed and won't kick in until Q2/09 at the earliest. But we would argue that although the news is bad, it is for the most part known and has been priced in.

At the same time that the trailing news and data about the economy is bad, we see many constructive developments in the economy. What are some examples? US stocks appear to have bottomed in November, the Baltic Freight Index (a proxy for global trade) is starting to modestly rise, basic functionality has been restored to the banking industries of virtually all countries, and the US consumer is deleveraging quickly. At the same time credit markets are thawing (as measured by LIBOR) and the daily volatility of the stock market has abated significantly (as measured by the VIX). And what about the cost of gasoline at the pumps?

The two DKAM funds own stakes in some of Canada's finest companies, many of which were acquired at rock bottom prices. Given the strength of the companies we own, and the valuation that they trade at, we are optimistic about the future .

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