

Early Signs Of Spring

Canadian financial services stocks began reporting their Q4/08 results in the middle of February and the last few companies are finishing up reporting as I put the final touches on this note. I have intentionally waited to see these results for a few reasons. First, it was my expectation that the majority of Canadian financial services stocks would report solid if not strong results – which they did. Second, I wanted to be sure that these same companies were entering 2009 with relatively clean balance sheets- which they are. Why are these two issues so important?

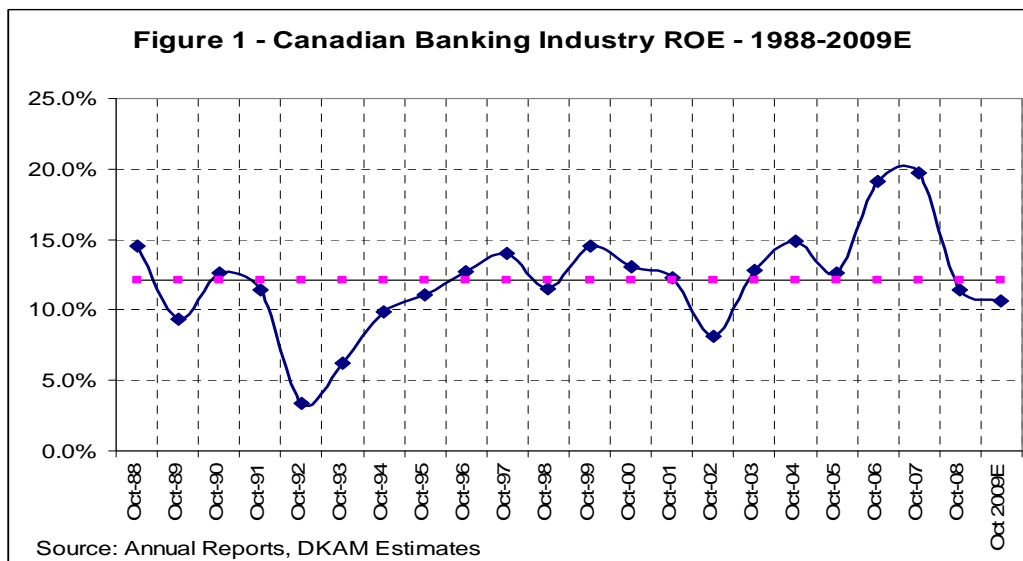
If a stock falls in price from \$100 a share to \$50 a share, but its earnings power on a go forward basis is unchanged, then the stock is now a bargain relative to where it was once trading. However, if the stock falls from \$100 to \$50 but the assets or franchise of the business have diminished by 50%, then the stock is no more or less attractive at \$50 than it was at \$100. Finally, if the stock falls from \$100 to \$50 and its business is even better now than it was when it traded at \$100, then the stock is probably now an extremely valuable investment. This, in my view, describes the vast majority of financial services stocks in Canada as we move our way through the first quarter of 2009.

To illustrate this point, let's look at Home Capital which has been one of the largest positions in the DKAM Financial Services Venture Fund since inception. Home Capital started 2008 with a share price of \$40.50 per share and book value per share of \$10.08. Over the course of 2008, the Company earned a profit of \$108.7MM (+20.5% yoy) and its book value increased to \$12.57 per share. During 2008, the company raised no money, raised its dividend, but still saw its capital ratios improve because of its higher retained earnings. Yet despite all these impressive accomplishments, the stock fell from \$40.50 at the start of the year to \$16.90 (-58%). Thus, while profits, capital ratios and book value each rose significantly in 2008, the stock's share price actually fell 58%.

However, there is more to the Home Capital story than its financial performance. While Home Capital was putting up impressive numbers throughout 2008 many of its most aggravating competitors either left Canada or expired outright. So why did they fail? As a generalization, they cut corners and underwrote business which might have made sense during ebullient times but did not make any sense when the music stopped. Home Capital, like the majority of Canadian Financial services companies, played by the rules (because OSFI, its regulator makes them do so and also because they have a smart management team) and thus while its competitors were failing throughout 2007 and 2008, Home Capital remained highly profitable. Thus, as we move into 2009, Home Capital is financially as strong as ever but most of its competitors are now gone. Thus, we believe the company is an even better investment today than it was a little over a year ago. Clearly, this is not the broken financial services company that you read about in the newspaper each day – this is reality.

But Home Capital is not alone. Fairfax and ING are now among the best capitalized P&C companies in the world, while our banks have soared in the global rankings of the best capitalized banks. Indeed, numerous publications and organizations have described our banking industry as the strongest in the world. Our life insurance companies have not fared quite as well but remain in much better shape than their peers in the US and UK. Finally, no major investment bank in Canada has come close to failing and publicly listed investment banks such as GMP and Canaccord remain well capitalized in absolute terms, and certainly in relation to their US and European peers.

While Canadian Financial stocks are priced for a depression, our major banks, insurance companies, asset management companies and custodians remain profitable – and not just marginally profitable – they remain highly profitable. For example, figure 1 below shows the profitability of the Canadian Banks over the past 20 years and it is clear to see that they are not only profitable, but are experiencing a much more modest downturn than they did in recession of 2002 or 1992 – although you wouldn't get that impression from reading or watching the business media.



So are we at an inflection point in markets?

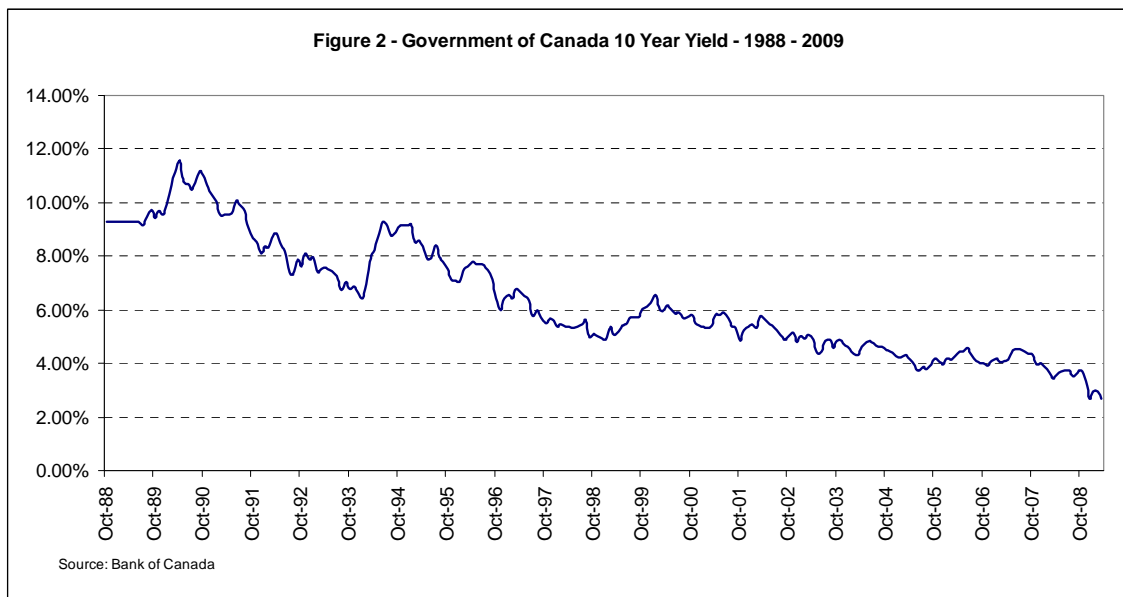
Nobody knows with certainty when the stock market will bottom, or if the rebound that has occurred over the past two weeks will be sustained. However, the past two weeks have clearly shown that a turning point in the market may be occurring. From my vantage point, the world is gradually normalizing and predictability is slowly returning to companies, industries and markets. As such, I am optimistic about the outlook for stocks while reiterating that I like others, have no ability to forecast the exact timing of a market recovery. That said here are my four reasons for optimism.

Reason # 1 – Many stocks are trading below replacement cost - In my opinion the best and certainly the most detailed book ever written on bear markets is Russell Napier’s “Anatomy of the Bear: Lessons from Wall Street’s Four Great Bottoms”. In this extremely detailed analysis of the four bear markets of the twentieth century; Napier asserts that severe bear markets find bottoms when companies begin to trade at significant discounts to their replacement cost. Thus, there are times in the stock market when it is significantly cheaper to buy a public company than start a similar company from scratch.

Napier defines net worth by using Tobin's Q which is sometimes referred to as the Q ratio. This ratio was developed by James Tobin and is calculated by dividing the market value of a company by the replacement value of equity. Despite the relatively straight forward notion of Tobin's Q, its implementation is more difficult than what first appears because the notion of replacement value is subjective and it is relatively difficult to measure Q over large numbers of companies.

That said, it is possible to undertake this analysis on individual companies and sectors and make an approximation of what the replacement costs are. In the case of the Canadian financial services industry, we have undertaken this analysis on the entire sector and found numerous companies trading below replacement cost. This list includes virtually all small cap financial services stocks and would also include companies like Manulife, Sun Life, TD Bank, Canaccord, Altus Group, The Equitable Group, Laurentian Bank and Fairfax Financial. However, the financial services sector is not the only sector offering such extreme bargains. A recent study by Wellington West suggests that the Canadian oil and gas services sector is trading at 50% of replacement value¹. This is consistent with market bottoms in the energy sector and suggests that extreme valuations are relatively widespread in Canada.

Reason # 2 – The risk free rate around the world is approaching 0. Over the past 18 months, central banks throughout the world have eased monetary policy to the point where government treasuries yield virtually nothing. What does this mean for investors like you and I? During periods of extreme financial weakness many investors will flee to assets that they perceive to be low risk – and government treasuries are the typical example. However, the movement out of riskier asset classes into government treasuries has exacerbated the deflationary cycle that is a normal part of any economic downturn. As such, central banks (led by the US Fed) are now attempting to deal with the deflation risk by driving the risk-free rate to 0. In other words, government policy makers are saying that there will be virtually no rewards other than capital preservation in holding the risk free assets (i.e. government t-bills, bonds, etc). For some that may be enough, but as investors begin to realize that government treasuries offer virtually no return, they will begin to look around for yielding assets. This process is called reflation or “the reflation trade” and its positive effects on asset classes including stocks should begin almost immediately.



¹ Mapping Out the Bottom: Energy Services Likely Close to Cyclical Low, Wellington West, Greg Coleman, Kim Page, March 16th, 2009.

Reason # 3 – Leadership from the financials – As our past research has shown, economic recoveries are almost always led by the financials. This is not because we are in love with the financials (although we have been sometimes accused of this) but because of the way the economic cycle unfolds. Typically, as an economy crashes, a massive liquidation of inventories occurs within companies and industries. However, pent-up demand eventually emerges and a restocking cycle begins. Once this restocking cycle begins financials intermediaries (banks, brokers, etc) must supply the capital (equity, debt, etc) that allows this cycle to unfold. At the same time, sentiment that has been focused on the downside risks of the economic cycle suddenly begins to recognize that an upside to the cycle also exists and risk premiums begin to normalize. Thus, as we move through the middle of a recession two things happen – earnings begin to recover and PE multiples begin to expand rapidly. This process can typically lead to very sharp upward moves in financial services stocks which may have begun over the past week or two. Using figure 3 below as a reference, we believe that the Canadian and US economy is probably exiting stage IV of the economic cycle and entering stage V as described in figure 3 below.

Figure 3 - 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 Computer Software Measuring & Control Equip. Computers Electronics Equipment Transportation General Transportation Shipping Containers	Basic Materials Precious Metals Chemicals Steel Works Non-Metallic & Metal Mining Capital goods Fabricated Products Defence Machinery Ships & Railroad Equipment Aircraft Electrical Equipment Services Business Services Personal Services	Consumer Staples Agriculture Beer & Liquor Candy & Soda Food Products Healthcare Medical Equipment Pharmaceutical Products Tobacco Products Energy Coal Petroleum & Natural Gas	Utilities Gas & Electrical Telecom	Financials Banking Insurance Real Estate Trading Consumer Cyclical's Apparel Automobiles & Trucks Business Supplies Construction Construction Materials Consumer Goods Entertainment Printing & Publishing Recreation Restaurants Retail Rubber & Plastic Textiles Wholesale

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

Reason # 4 – Consumer stability – for years various pundits have predicted that the “consumer” was about to “fall off a cliff” for reasons ranging from excess consumption to sub prime debt. Further, if you are a “talking head” on TV it is quite normal to talk about the “consumer” as if he were some kind of careless moron with no sense of judgment or ethics. Well guess what? Everybody reading this letter is the “consumer” and you are probably not a moron! Indeed, what these pundits fail to appreciate is that households are in fact far more rational than they are given credit for. For example, when banks lend money on easy terms the consumer is more than happy to take it. However, when circumstances change, the consumer reacts quickly to reposition his consumption and savings to the new reality. Thus, predictions of the demise of the consumer are typically overstated if not wrong. In fact, I believe that households react much faster than either corporations or governments because households can make very severe decisions and do so quickly.

So why is this important? Economists believe that 70% of the economy is driven by consumption and the past few weeks have seen consumer data that was surprisingly robust. This data has come from both sides of the border and suggests that consumption patterns in many categories (including retail and autos) are holding up better than expected or even returning to normal. In Canada, retail sales for January rose 1.9% while in the US advanced monthly sales for retail and food services were down 0.1% over the previous month. If the consumer and housing markets are in fact in better shape than the pundits have suggested, than a recovery in the stock

market may well come sooner and be far more positive than anyone is expecting. The general rule on recoveries is the sharper the downturn, the sharper the recovery.

The market is feeling like its ready to go higher

The TSX hit a new bottom in early March (March 9th to be precise) and has been steadily rebounding since then. Year to date, both DKAM funds have performed well. The DKAM Financial Services Venture Fund is up 4% year to date (versus the financial services index which is down 3%) and the Capital Ideas Fund is up 7% (versus the S&P TSX Composite index which is flat on the year). We remain optimistic about the outlook for our investments in each fund and expect both funds to perform well over the balance of the year.

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