

A Double Whammy is Not a Sandwich

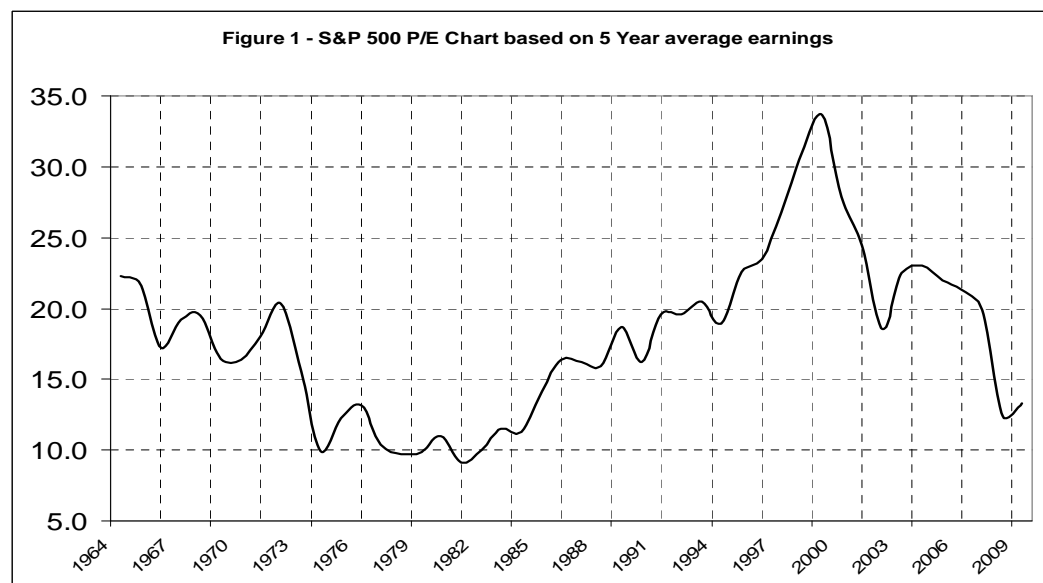
The world is not coming to an end. Indeed, the rally in equity markets over the past three months has allowed investors to realize that there is another (positive) side to the investment coin. Thus, while the economic news that we read about each day swings back and forth from positive to negative, the market is at least now prepared to acknowledge that some positive developments are occurring in the economy. Our expectation is that the markets will continue to perform well this year. However, it should be noted that while we are encouraged by macro events, our bullishness stems from our perspective on both market and individual stock valuations. In short, we continue to have little difficulty in finding great companies to invest in that are trading at low multiples of earnings and book value. This makes us very positive for the future.

Why is valuation so important?

Before we address the idea of valuation, I refer readers to Figure 1 which is the P/E Chart for the US S&P 500 Index that goes back to the early 1960's and is current up until today. I will use this figure as a proxy for the market in both the US and Canada as it is easier to obtain long-run data on the US markets than it is in Canada - but my comments apply equally to both the Canadian and US equity markets. Figure 1 depicts the P/E ratio for the US market over the past 45 years with the earnings derived from the 5 year moving average of S&P earnings. Thus, the earnings numbers used in Figure 1 have removed much of the cyclicality from year to year earnings. From this figure we can make several interesting comments about today's market.

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

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First, over the past 45 years the US market has traded within a very large P/E valuation range, with the high (roughly 34x) occurring during the tech bubble in 2000 and the lows (around 9-10 x) achieved during the 1970's and early 1980's. Second, it is now clear that with the exception of the period 1997 to 2001, the market has typically traded at a P/E multiple of between 10 and 22.5 x "normalized earnings". I have put "normalized earnings" in quotation marks for a reason as some of my subsequent discussion will look at P/E ratios that use annual earnings as opposed to smoothed or "normalized earnings". The point here is that notwithstanding the recent bounce back in equity markets over the past three months, the S&P remains reasonably priced (but not rock bottom cheap) in an historical "normalized" context.

Why is this discussion about P/E so important?

A stock's future performance can be broken down into a combination of factors that add up to its total return. In the simplest terms, a stock's returns consist of the capital appreciation of the stock and the dividends received. However, we can take a stock's capital appreciation and break it into two pieces, namely the change in its earnings and the change in the multiple at which the stock can be bought and sold. Thus, if a stock's earnings double and the P/E multiple that it is valued at stays the same, then the capital appreciation is equal to the earnings growth and thus there has been no multiple expansion. However, if the stock has risen faster than earnings we can say that there has been multiple expansion, and conversely if the stock rises slower than earnings we can say that there has been multiple contraction. Ideally, investors seek to identify markets and stocks that will enjoy strong earnings growth and multiple expansion.

So how important is multiple expansion? Some pundits, such as Keith Wibel of Foothills Asset Management, believe that the expansion and contraction in the market multiple is the primary determinant in the market's performance. Figure 2 presents data from the period 1950 to 2000 that highlights Wibel's argument and shows that there is a relatively low correlation between EPS growth rates and index performances. For example, for the S&P 500 the 1970's saw the highest EPS growth rate but the poorest index performance. The lowest decade in terms of EPS Growth was the 1950s yet it resulted in the second best decade to own stocks. On the other side, we see that two of the three best decades for stocks started with extremely low valuations, while the most expensive decade (the 2000's) has yet to finish but appears in hindsight to have been a terrible decade to own stocks.

Figure 2 - Changes in P/E Multiples Relative to Earnings for the S&P 500

Decade	Annual Change		P/E Ratio		PE Multiple
	EPS	Index	Beginning	End	
1950s	3.90%	13.60%	7.2x	17.7x	Expanded
1960s	5.50%	5.10%	17.7x	15.9x	Stable
1970s	9.90%	1.60%	15.9x	7.3x	Contracted
1980's	4.40%	12.60%	7.3x	15.4x	Expanded
1990s	7.70%	15.30%	15.4x	30.5x	Expanded
2000s	?	?	30.5x	?	Contracted so far

Source: Keith Wibel as quoted in *The Big Picture*, Barrons, August 27 2005

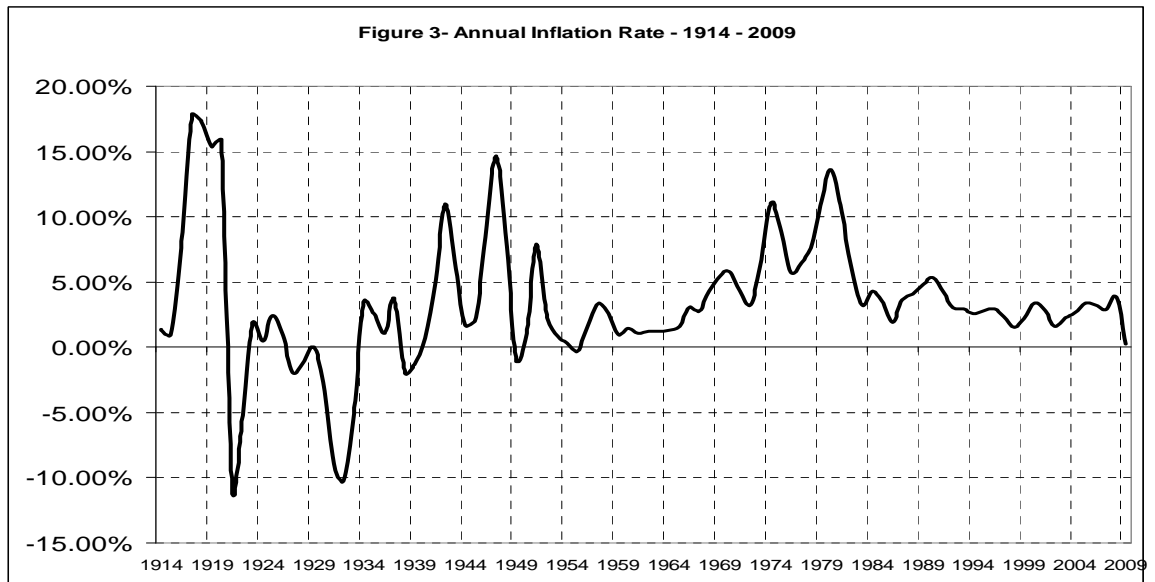
It should also be pointed out that Wibel's data does not use "normalized" earnings so his PE ratios differ from those in figure 1. However, the point that we would conclude from both Figure 1 and 2 is that valuation and the potential for multiple expansion is extremely important and that the market started this decade at an extremely precarious valuation level.

So where is our starting point and where are we going?

Our view is that stocks are now reasonably priced and trading in the lower half of the normal historical valuation range and thus the risk of multiple contraction is modest. However, as the two preceding figures have shown, the valuation of the market only gives one a sense of the probabilities of market P/E multiples expanding, contracting or staying the same given a specific starting point. Some theorists, such as Ed Easterling of Crestmont Research argue that predicting whether P/E multiples will expand or contract centers on a view regarding inflation trends. The question of course is whether or not we are entering a period of rising inflation?

There are really two camps out there on the question of inflation. The pessimistic camp argues that central banks throughout the world are printing money at a tremendous pace to re-start the global economy – and that this will lead to a period of rapid inflation not too far down the road. Implicit in this view is that the central banks do not know or understand what they are doing. The second camp argues that central banks throughout the world are printing money at a tremendous pace to stave off deflation in the short-term and the central banks will turn off the taps at the first sign of serious inflation or hyperinflation. This camp believes that the central banks have some skill and understanding in what they are attempting to do vis-à-vis monetary policy. So which camp will be right?

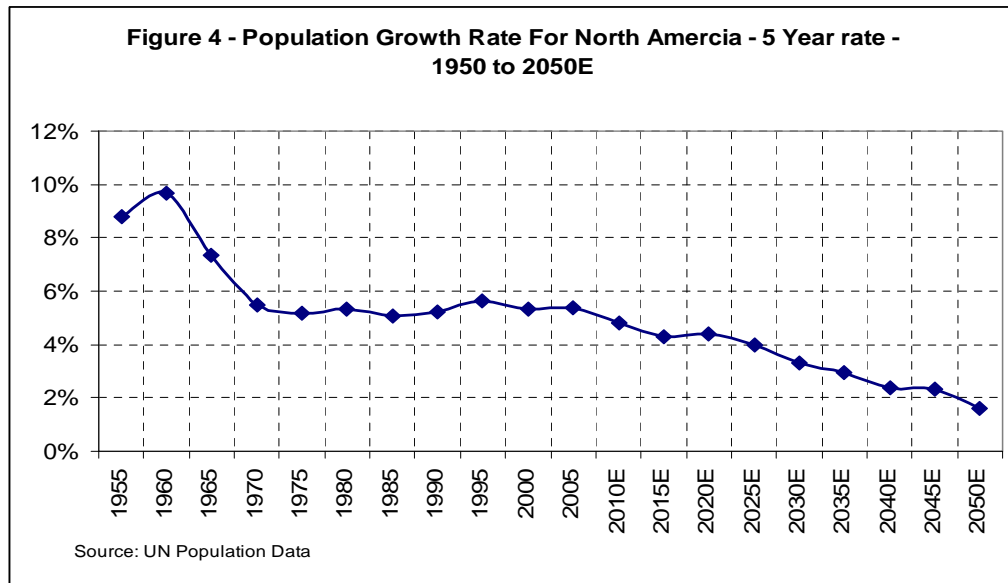
To help answer that question, let's look at 100 years of inflation data from a US perspective as presented in Figure 3. From my analysis of the figure below I would argue that over the course of the past 100 years the US Central Bank has become increasingly proficient at managing and preventing instability in prices (i.e. managing both inflation and/or deflation). The second point I would make can be made in terms of a rhetorical question which is “looking at Figure 3, if you were the head of the US central bank, would you be more concerned with inflation (above 5%) or deflation (0% and below). In my view, deflation is their bigger worry.



The Monetarist versus the Demographers

As the father of monetary economics, Milton Friedman’s most famous quote is that “inflation is always and everywhere a monetary phenomenon”. Friedman’s academic work centered on the notion that inflation was generally caused by excess money supply created by central banks. However, Friedman also argued that deflationary spirals were at least exacerbated by the failure of central banks to expand the supply of money during a liquidity crunch. Thus, the recent actions of the major central banks and the US Fed in particular in the short-term are consistent with monetary economics. However, beyond the monetary phenomena, inflation is also caused by changes in the supply and demand for goods and assuming that the US Fed and other central banks can stave off the short-term deflationary spiral, I believe the next most important factor to consider in assessing the potential for an outbreak of high levels of inflation are national and global demographics.

The case study for the impact of changing demographics on inflation is Japan over the past twenty years. In the late 1980’s the Japanese experienced an asset bubble and at the same time entered a period where its dependency ratio¹ began to surge. Thus, a bursting asset bubble combined with the onset of a rapidly aging population resulted in a long period of below normal growth and deflation. Fast forward to the current decade and we are seeing the global economy dealing with the bursting of a significant asset bubble and the beginning of a sustained period of slowing population growth (although nowhere near as severe as Japan). As such, my view is that the global economy’s biggest worry is not inflation but Japanese style deflation.



Hedging our bets

The preceding analysis sought to show two things. First, that valuations are reasonable in a long-term context and second, that the probability that inflation will become a big issue and therefore compress P/E multiples is relatively low in the short to medium term. Thus, we believe that stocks should perform in line with or slightly better than the market’s earnings

¹ Dependency ratio – ratio of the number of persons under the age of 15 and older than 65 relative to those people between the age of 15 and 65.

growth rate on a long-term basis. But what if we are wrong and inflation does come roaring back or valuations don't turn out to be as low as we have assessed them to be?

Well, let me start by saying that we are not top down investors for a reason. We continue to believe that it is much easier for investors to identify strong companies and reasonably priced stocks than it is to predict the future direction of interest rates or inflation. As such, even though we believe the market is attractively priced at a macro level, we can protect ourselves by making sure that the investments we own are priced at low multiples of earnings and/or are growing at rates that are significantly higher than the market. If we are truly worried about inflation we should also look for companies that have the ability to pass through possible costs in their inputs. Here's a brief description of our top ideas going forward.

In search of the "Double Whammy"

The Double Whammy is not a sandwich. If we can buy a company that trades for 6x earnings and that company doubles its earnings in 5 years and we sell it for 6 times earnings, then we double our money. However, if we can buy a company for 6x earnings and the company doubles its earnings in five years but we can sell it for 12x earnings, then we have quadrupled our investment. The first company delivered a compound investment return over the five years of 14.9% while the second delivered a compounded investment return of 31.9% over the same time period. The expansion in the P/E multiple is one of the keys to outsized gains in equity markets. At DKAM we are looking for stocks that can deliver a "Double Whammy" which are stocks that have 1) above average earnings growth and 2) a P/E ratio that is dramatically lower than the market. Here are some of our best Double Whammy candidates.

Double Whammy Candidates

Cyberplex - has been one of the star performers of the 2009 stock market but we think this stock can go much higher in the coming months. I like to think of Cyberplex as being akin to Google but in the case of Cyberplex you get results instead of eyeballs (page views). We see this company growing by 65% in 2009 and it trades on a 2009 P/E ratio of 5.2x. With the market trading at 13.5x normalized earnings, Cyberplex could triple if it simply traded up to the market multiple. The stock also trades at 2.5x bvps, which is extremely low for a stock with an ROE over 60%.

Alliance Grain Traders - is based in Regina and is effectively the largest processor and middle-man in the pulse grain market in North America. Pulse grains include peas, chick peas, legumes, lentils and beans. Alliance has a very impressive CEO, trades on 4.5x 2009 earnings and 1.4x bvps. This is another stock that could triple as it is growing at a 34% annual rate. The symbol is AGT.UN and the market cap is \$133MM.

First National Financial Income Fund - Is a mortgage lender and income trust that boasts a yield of 14.1% with a pay-out ratio of 78.9%. The Company derives its income from residential and commercial lending and from a large base of mortgages that it receives servicing fees for. The Company is in my view an excess cash-flow machine and is an excellent candidate for a take-out. The management of this Company is very sharp and they own 80% of the stock. The stock trades on 5.6x 2009 earnings.

Glentel - Every time somebody comes out with a new cell phone that you just must have, chances are they are going to buy that phone at Glentel. Glentel has two operating divisions - retail and business - that offer telecom services throughout Canada. Glentel's retail division operates 265 locations across Canada including WirelessWave, Tbooth/La Cabine, and

Wireless etc. With the rapid changes occurring in cell phones and related devices, we think Glentel will continue to put up big numbers. For 2009 the stock trades on 6.2x 2009 earnings, 1.5x bvps, has a yield of 5% and is growing at a 23% growth rate.

Freehold Royalty Trust – Is one of the largest owners of energy mineral rights in Canada. An investment in this Trust allows investors the benefit of sharing in production revenue without the costs or hassles of normal oil and gas operations. The Trust is managed by its largest shareholder, namely the CN Pension Trust. Freehold's long-term outperformance relative to its peer group is significant and for those who are bullish on energy prices, Freehold is a great buy. The stock trades on 6.8x earnings with an 8% yield and with oil prices where they are now; there is a reasonable chance that its distribution will soon rise. We expect the Trust to grow by 28% in 2009.

Concluding remarks

We are optimistic that the market will continue to perform well for the balance of the year. The DKAM Capital Ideas Fund is up 35% YTD while the DKAM Financial Services Fund is up 23% YTD. These are fascinating times. Call me if you want to chat – 416 – 364 – 8886.

JP Donville