

The Watch That Ends the Night

If you watch business TV on a regular basis, as I do, you will hear various market pundits providing their views on every issue ranging from interest rates to the number of wins the Toronto Maple Leafs might eke out this year. I quite enjoy listening to these pundits, even when they disagree with my own views because they are generally well spoken and their ideas force me to think through my own ideas. So here's "my" one minute sound bite on the markets and where we are heading from here.

If one looks back at the economic cycles of the major western economies over the past 30-40 years you would see that our economies tend to experience fairly consistent cycles that can be subdivided into 1-2 year segments of weak or negative GDP growth (the down-cycle) followed by 4-7 year segments of moderate to strong GDP growth (the up-cycle). This relatively consistent pattern has occurred because central banks working in concert with national governments have become reasonably adept at using both monetary and fiscal policy to smooth out the ups and downs of the broad economic cycle. As such, with the global economy having experienced roughly 8 weak quarters (from Q3/07 to Q2/09 inclusive) it is my belief that we are now somewhere in the first year of the next up-cycle. This, like most of the past up-cycles, should last anywhere from 4-7 years. And that's it - that's my big picture, top down, macro perspective on the world.

Does this sound too simplistic? OK, it probably is and I can assure you that I could describe the ideas that I have put forward in the previous paragraph in more sophisticated and technical jargon, backed up by pages and pages of data, charts and analysis. However, it does provide a lead in to my main point, which is that my macro view (or anyone else's for that matter) is probably not what served you best or worst in either the latter half of the last down-cycle (2008 and early 2009) or the early stages of the current up-cycle. That is because nobody gets the macro call right with any kind of consistency – and so I ask, why build an investment strategy around the macro call?

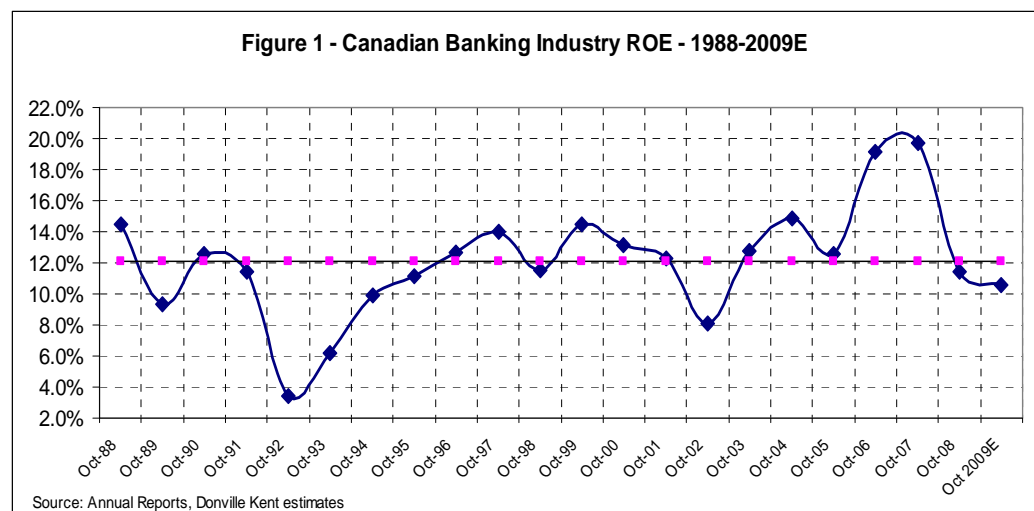
Given the outrageous stresses that investors have experienced over the past 24 months, what kind of system can an investor build his investment strategy around? My belief is that outstanding companies with big moats (i.e. a competitive advantage that drives a high ROE) can be objectively and readily identified and that this is the core principle that should drive your investment strategy – it certainly does ours. Put another way, we believe that we have

much better odds at identifying companies today that will still be outstanding 2 or 3 years from now than we will at guessing the Can/US exchange rate or the price of copper a year from now. At Donville Kent, we believe that companies such as Home Capital, MTY Foods, First National, Constellation Software, Canadian Western Bank, Freehold Royalty, and Logibec, just to name a few, are outstanding companies today and we can say with a high degree of certainty that they will continue to be outstanding companies next year, the year after that, and the year after that.

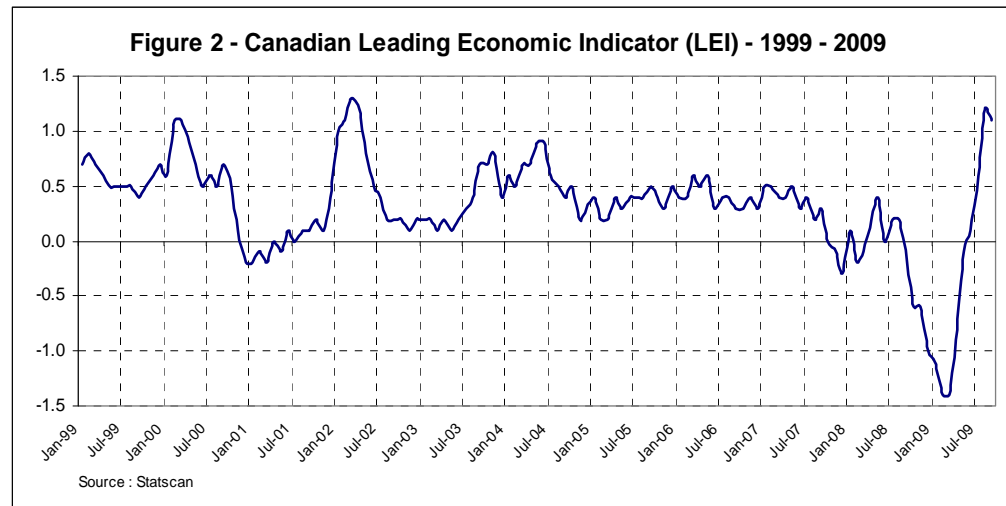
Be fearful when others are greedy and greedy when others are fearful – Part 1

Most of our readers will know that the title above is actually an often cited quote from Warren Buffett. This quote is one of his best and has been used with increased frequency over the past 12-24 months as markets, companies and personal portfolios were trashed from the middle of 2007 until early 2009. However, the past 6 months have seen a sharp snap-back rally and it begs the question, are the markets still fearful or have we become greedy again? My sense is that there is still a fair amount of fear out there and that markets remain attractively priced in relation to earnings and prospects for future growth. Here are my thoughts in a nutshell.

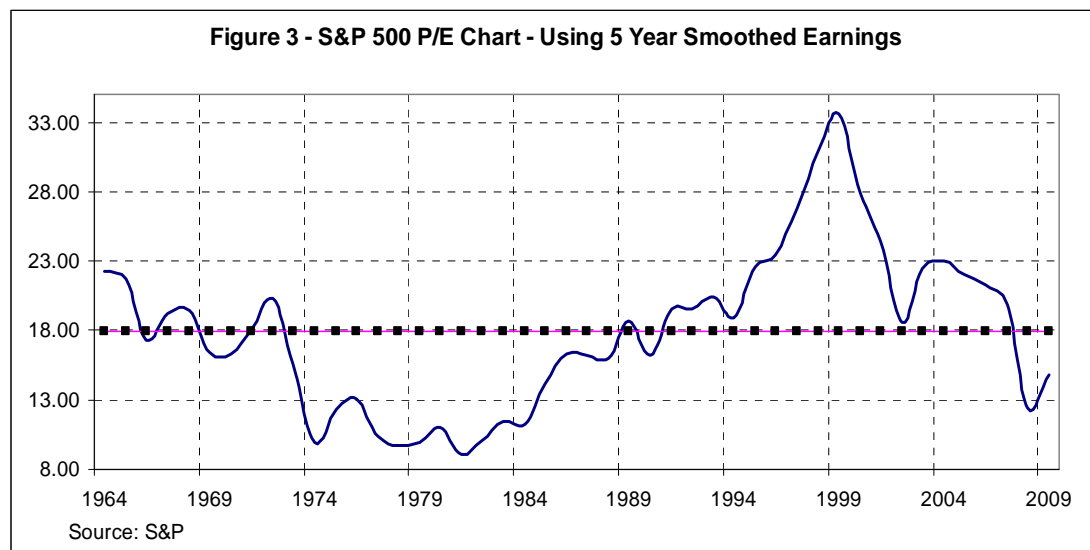
Last year's economic and stock market collapse was caused by the dual events of 1) a widespread banking industry failure layered overtop of 2) a normal economic downturn. Since the middle of 2008 those countries with failing banking systems (much of Europe and the US) have recapitalized and/or nationalized their banking system. However, let's not forget that a significant number of countries did not have to bail out their banking industries. No major banks in Canada were bailed out in any significant way and as we see in figure 1 below, our banks are actually much more profitable at the bottom of this current cycle than they were at the bottom of the 2001-2003 recession or the 1991-93 recession. Similarly, most Asian banks sailed through the 2008 downturn and have reported strong levels of profitability so far in 2009. As such, half the reason for being fearful in 2008 has largely disappeared.



With the risks of a systematic banking failure now off the table, the key risk for investors (we are told) is that we will face a slow economic recovery over the next two-three years and possibly a double-dip back into recession. Once again, there are no shortages of pundits who can pontificate on this issue (positively or negatively) but fortunately we have a wonderful organization in this country called Statistics Canada (Statscan) which puts forth a monthly statistic that gives us a fairly objective measure of where the economy is heading. That statistic is called the Canadian Leading Economic Indicator (LEI) and it consists of a 10 component time series that tracks changes in the direction of key sectors of the economy. The LEI turns before the economy and the overall composite index provides an early indication about impending changes in the course of the economy. Figure 2 below presents the LEI going back over the past decade and it clearly suggests that not only is the economy on the mend but that economic activity in Canada over the next 3-6 months should be robust.



The final variable worth considering in our greed versus fear analysis is valuation – is all of the good news that we have discussed above already priced into the market? In this context we shall look at US valuations as we have a much longer historical time series from which to assess the valuation of the market. As we see in figure 3 below, valuations in the US remain reasonable in relation to historical norms. Clearly, as bad as the 2008 sell-off was, valuations never fell to the levels that they did in the mid 1970's but valuations today nonetheless remain 18% below the long run average. It is therefore hard to argue that the US market is overvalued today and it is our belief that the Canadian market is similarly undervalued.



In my opening comments to this newsletter I opined that one should not place a great deal of emphasis on the macroeconomic outlook. However, as figures 1, 2 and 3 have shown the macro picture, for what it's worth, does look fairly positive. Thus, as I said at the outset, I remain convinced that we are somewhere in the first year of an up-cycle that I expect will last approximately 4-7 years. Indeed, the past six months have been the watch that ends the night!

The Beauty of High ROE Investing and the Oil Patch

I recently had a chance to visit a number of oil and gas companies in Calgary. Readers of this newsletter know that we are ROE investors but when we read through oil and gas annual reports we rarely see much mention of ROE or any other rate of return concept. However, just because the industry doesn't describe itself with the same type of jargon that we use does not mean that the principles that drive our investment framework don't apply elsewhere. So here are our thoughts on this issue.

Finding high ROE companies is reasonably easy to do but the real fun is peeling away the layers of the company and industry to reveal why the ROE is high and if in fact it is sustainable. DuPont analysis, which breaks ROE into its five key components, is for us like a diagnostics tool kit that allows us to quickly isolate which factor in a Company's business model is driving its ROE.

As an aside, the development of DuPont analysis has an interesting story in its own right. In 1914, a young chemical engineer named F. Donaldson Brown joined the DuPont chemical company and quickly rose through the ranks within the company's treasury department. During this time, Brown began to devise objective measurements for allocating capital as DuPont sought to evolve from a narrowly focused company to one that was broadly diversified. In 1918, DuPont bought a 23% stake in GM and Brown was subsequently brought in to help turn the business around. At the time of the purchase, GM had 12% market share and by the 1950's when Brown retired, GM's market share exceeded 50%. Alfred Sloan, the mercurial CEO of GM credits Brown and his analytical framework for turning the company around in the 1920's and paving the way for its subsequent success.

Most high ROE companies fall into one of three categories, namely the highly levered company, the high through-put company (as revealed by the asset turnover ratio) or the high margin company. Of the three, we are mainly looking for those companies that fall into the latter category, namely the high margin company. But what is a high margin company? A high margin company is a company that can sell its products or services for a premium to what it costs to make the product or deliver the services. Microeconomic theory suggests that the ability to sell a product or service for more than its cost of production is typically unsustainable because new entrants will emerge to take advantage of those excess returns and will continue to enter the industry until the selling price is roughly equal to the cost of production (marginal cost = marginal revenue). However, some companies can sell their products significantly above the cost of production for years and even decades and they typically do so because they have some type of competitive advantage. Thus, when we find a company that has had an above average ROE our first objective is to dig beneath the surface of the company so as to assess why the ROE has been so high and whether or not it's sustainable.

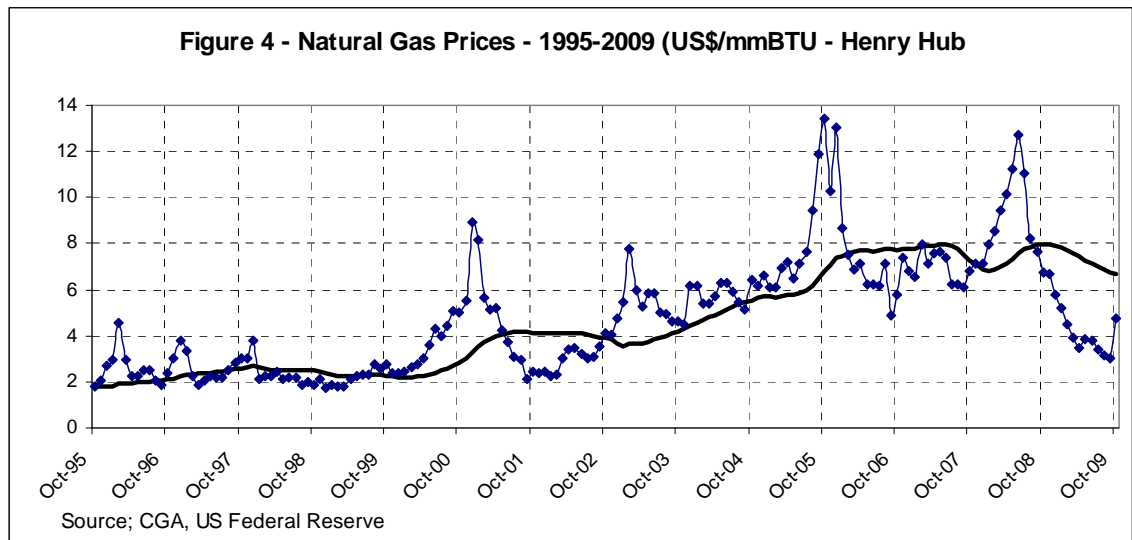
We think most investors do not look at the oil and gas industry the way we do, in part because commodity businesses are perceived to be price takers while most ROE analysis focuses on a company's ability to be a price setter - to pass on its costs plus a profit margin to its customers. In the oil and gas industry, everyone is a price taker - i.e. a barrel of oil is a barrel of oil. We certainly understand this because most of the high ROE companies we found in other industries had tremendous pricing power and within reason could dictate to the market the price that would be paid for said goods and services on the strength of the competitive advantage inherent in the business.

In the oil and gas industry we found a dynamic in place that is different from most other high ROE industries. In the oil and gas business, the high ROE Company's competitive advantage tends to come from its cost structure and appears to be the key to maximizing its netbacks (the amount the oil and gas company keeps after it has covered its costs of getting its product to market). This low cost advantage was typically the result of the fortuitous nature of the specific asset that a said oil and gas company was harvesting but this generalization misses the fact that there is a great deal of managerial savvy at the top of some of these companies. Thus while a high ROE company might be perceived as simply those that stumbled across relatively inexpensive assets to harvest this negates the fact that the best geologists are not simply seeking oil and gas - they are seeking those oil and gas plays that are cheapest to harvest. Managerial talent also comes into play on how a management chooses to concentrate or disperse its producing assets. Thus, we believe that ROE analysis is useful in identifying low-cost producers in the oil and gas industry, and (subject to valuation) low cost producers are the ones we want to own in any commodity related industry.

Be fearful when others are greedy and greedy when others are fearful – Part 2

Our recent trip to Calgary was primarily to visit companies with a big exposure to the gas industry (as opposed to oil). Our motivation was driven by the fact that we were able to identify several gas-weighted companies that were still quite profitable even after natural gas prices had collapsed below the long term moving average - see figure

4 below. As figure 4 shows, gas prices hovered near \$2-3 per mmBTU for much of this past summer, and near lows set during the last economic downturn in 2001.



Of course, the price of gas does not fall to the level seen in 2001 or the summer of 2009 without there being plenty of fear to go around. Equally, the spikes seen in June 2008 and October 2005 suggest that there have been times of late when there was plenty of greed to go around. Now back to Buffett – “be fearful when others are greedy and greedy when others are fearful” and let’s look where the fear is coming from.

The fear on gas prices is coming mainly from two sources. The first is on the demand side. Gas prices are currently low because aggregate demand in North America is low, and therefore there is a glut of gas in storage or waiting to be tied into the market. No problem with this – it was the same story in 2001. Therefore, if you believe that the economy has bottomed and will turn up on a go forward basis, then this issue is a cyclical factor that will simply go away with time.

The second fear is that new technologies have allowed gas fields that were previously uneconomic to suddenly become economic and therefore expand the amount of supply that is available at a certain price. This is a far more important concern. These gas fields are located primarily in geological resources that are referred to as “shales” and are located throughout North America. When these unconventional plays were first harvested a few years ago they produced gas at a relatively low cost in relation to their development costs and thus the view was that these ‘plays’ would drive down the industry’s marginal cost dramatically. However, as these shales have been further developed, decline rates (the rate at which a well’s production declines) have been much higher than expected, suggesting that the initial assessment of the shales economic attractiveness might not be as high as initially perceived. Thus, the fear posited by the unconventional shales is not insignificant.

Adding to the interest of this sector was the fact that the share prices of many of the best gas weighted companies were down 65-80% from their recent peaks and some of the best junior companies were trading at between 1-3x CFPS and deep discounts to NAV. These CFPS multiples and NAV’s were based largely at “bottom of the cycle”

energy prices, leading us to conclude that now was the time to be greedy – which we have indeed been.

We have met with several gas weighted companies over the past 6 weeks and Berens was the one we liked the most (and we own it in size). The Company has a market cap of about \$115MM and management owns 23% of the company. What we like about the company is that it is cheap (about 2.7x 2010 Cash Flow), gas weighted (about 80%), and possesses a bottom-quartile cost structure. The latter point is important because if gas prices go nowhere or even down, Berens will remain very profitable. The final point that we like is that there is also significant speculative upside given Berens' exposure to the Cardium play in West Central Alberta. Besides Berens (BEN), we also hold good sized positions in Painted Pony, Cinch, Freehold, Antrim and Culane.

Final remarks

The market has been on a pretty steady run since the middle of March and has been correcting since the end of October. We do not know how long this correction will last but we remain optimistic on the outlook for both of our funds given the high level of profitability of our largest positions and their reasonable valuations in relation to that profitability. Year to date, the Capital Ideas Fund LP is up 59%, while the Financial Services Venture Fund LP is up 41% versus the TSX Composite which is up 22% this year.

Call if you want to chat – JP Donville – 416-364-8886

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