"The devil is in the details"
Anonymous

Happy New Year!

We hope that the year 2002 brings many blessings and much happiness to you and your families.

The last quarter of 2001 turned out to be a momentous one. The tragic events of September 11 shocked and saddened all of us. War was officially declared on terrorism and all those who perpetuate and harbor its evil deeds. Afghanistan was the first target and by year end the Allies had routed the opposition forces and taken control of the country. Finding Osama bin Laden has proven to be far more difficult.

After a temporary closure North American Equity markets fell sharply and bottomed on September 21, 2001. However, by year end all of September's losses had been more than recouped. During the fourth quarter of 2001 the major Canadian and American equity indexes rose approximately twenty per cent. Patriotism and then relief that the terrorists hadn't made another catastrophic strike initially fueled this rise. The Federal Reserve in the United States helped equity markets by aggressively increasing the money supply and continued to reduce interest rates until they reached all time lows. Despite the strong rise in markers since September 21, 2001 and aggressive attempts by the monetary

authorities to stimulate the economy North American markets still ended the year with losses. The TSE 300 lost 12.5% while the NASDAQ and S & P 500 lost 20% and 11% respectively.

PCM 's portfolios held up quite well. The composite return on our taxable portfolios was approximately 6.5%. Our non-taxable portfolios returned approximately 18.5%. We are quite pleased that we have outperformed our benchmarks by such dramatic amounts during 2001. We would however, caution that this level of outperformance relative to our benchmarks is unusual and may be harder to achieve in the future.

The collapse of energy trading giant Enron Corp. could turn out to be one of the most significant financial events in recent memory. It was only recently that Enron was considered a rising corporate star. The company's trading operations had apparently melded the new economy's internet based technology with the old economy's need to trade and hedge a "hodge podge" of commodities; most notably oil and gas. The company was reporting strong growth in revenues and profits and, at its peak, reached a market value of more than eighty billion dollars.

However, Enron's rules of the new economy collided with the old laws of economics under the glare of regulators. As it turned out Enron's growth was a myth created by complex accounting and "off balance sheet" transactions. The legality of these transactions and disclosure relating to these items is now being investigated.

Many high profile institutional investors and mutual funds were caught holding Enron as it went into bankruptcy. Tragically many Enron employees' retirement plans were shattered, as the largest holding in their retirement fund was their employer's stock. Not surprisingly investors, regulators, politicians and the media are calling for inquiries and looking to place blame in the largest bankruptcy in history. The questions are starting to focus on the company's management and on Enron's auditors.

Stock markets have turned bearish as fear of further accounting abuses permeate. The media has labeled the current situation a "Crisis of Confidence" in the accounting profession. Calls are now being made for an accounting oversight board; in effect an auditor for the auditors. Staffed of course by auditors!

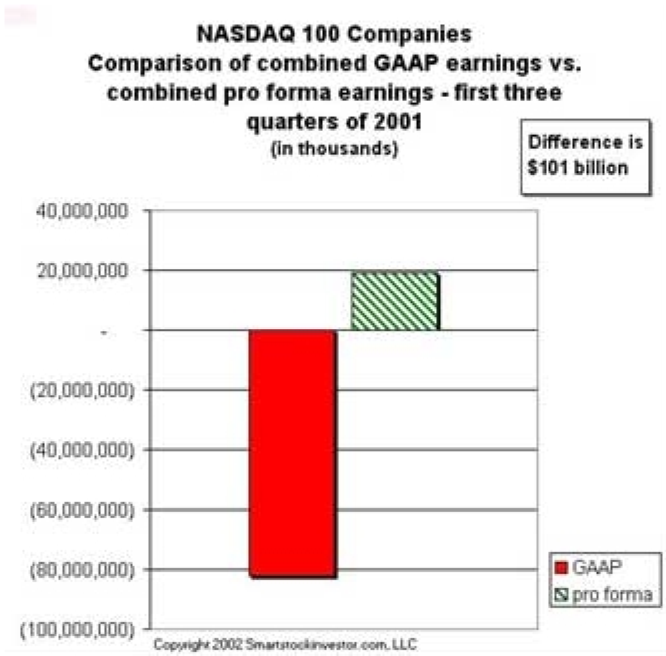
As usual at PCM we have a different view. We believe that investors have no one to blame but themselves in such situations. During financial bubbles investors ignore the basics. As a result, conservative companies are penalized relative to their more aggressive counterparts who are showing strong "earnings growth." Before long a good number of corporate executives feel compelled to play the same game for fear of being left behind.

Generally Accepted Accounting Principals, (GAAP) is the language of business. It has survived and evolved over a very long period of time. While it is very true that managements and auditors often present financial statements in a manner, that portrays the company in the most positive light, the notes to the financial

statements provide a wealth of information that in most cases reveal the true picture. As is often said "the devil is in the details." It is the task of analysts and investors to closely examine these notes.

In our view, a thorough analysis of a firm's financial statements is an integral part of the investment process. To do anything less is a breach of fiduciary responsibility. To rely on brokerage firm analysts for a definitive opinion is nothing short of an abrogation of responsibility and extremely naïve. In addition, to rely on anything but annual and quarterly reports filed with the SEC or OSC is dangerous. However, today many investors are placing their faith in "pro-forma" earnings announced by many public companies and reported without question by the media and analysts.

These "earnings" are not filed with the regulatory authorities nor are they audited. In essence public corporations can and often do present these financial statements in any manner that they wish. In an excellent article posted on SmartStockInvestor.com, <u>NASDAQ 100 Companies Report Combined Losses of Over $82 Billion to the SEC While Reporting Profits of $19 Billion to Shareholders,</u> the author John J. May discusses how some of the largest and most prominent companies in the NASDAQ report vastly different numbers to the SEC and to their shareholders. The chart below (also from the above noted article) nicely summarizes Mr. May's findings. A difference of $101 Billion exists between the earnings reported to shareholders and those reported to the SEC! When one considers the valuation of the NASDAQ in this context the implications are truly frightening!



The problem is pervasive. Companies in the S & P 500 are also playing the same game. In an insightful article posted on thestreet.com, <u>Pricey Stocks Risk a Fall Into the GAAP</u>, Justin Lahart also points out the large discrepancy between GAAP earnings and pro-forma earnings. Mr. Lahart states: " When we look at company earnings on a GAAP basis, the true depth of U.S. companies" sordid affair with pro-forma accounting reveals itself. Current estimates suggest that S & P 500 companies will have earned about $410 billion in 2001 on a First Call basis. On a GAAP basis, however, they earned just 58% of that, or about $240 billion. A $170 billion difference."

We at PCM have been troubled about accounting issues for some time. In our First Quarter, 2001 Newsletter we outlined our views. Over nine months ago we wrote:

"We are also quite concerned at what we are discovering when we analyze the financial statements of many companies. Our analysis has uncovered one or more of the following on a frequent basis:

- ***"non-recurring" charges that continue to recur***
- ***earnings increases arising from unsustainable non-operating items such as pension plan gains and investment gains***
- ***dramatic increases in deferred charges***
- ***increasing debt levels; often as a result of funds used to repurchase very high priced stock***
- ***the use of risky financial instruments to offset the cost of share repurchases***
- ***a large percentage of reported operating cash flow from tax credits received by the corporation on the exercise of employee stock options***
- ***acquisitions consummated at extraordinary valuations***

Most disconcerting is the fact that many management teams felt the need to meet "street estimates" or "whisper numbers" at virtually any cost. Failure to meet expectations by even a penny led to punishing declines in their company's share price and the value of their options. We are now starting to hear of management

decisions that were essentially driven by the need to meet short term quarterly expectations. We are certain that more harrowing tales will emerge as the inevitable consequences of robbing Peter to pay Paul come to pass."

When we wrote the above little did we know the storm that was to come so soon.

You can rest assured that at PCM we only rely on audited numbers that we thoroughly analyze ourselves. We spend a considerable amount of time going through the financial details. Along with our valuation work and discussions with managements and industry specialists our portfolio is a direct result of this analytical process. A process that has led us to an extraordinarily high cash position and a portfolio that makes us extremely comfortable today.

Vito Maida

January, 2002