"Whenever you find yourself on the side of the majority, it's time to pause and reflect."
Mark Twain

North American Equity markets posted strong results in 2003. Returns for the year were 26.72%, 28.68%, and 50.01% for the TSX, S&P 500 and NASDQ respectively. These spectacular performances were a welcome relief after three consecutive years of difficult equity markets.

Investors were buoyed by the success of U.S. troops in Iraq during the second quarter and surprisingly strong economic reports during the second half of the year. A host of positive economic reports encouraged investors to believe that significant growth was in store for 2003 and 2004. Stronger than expected manufacturing data, employment statistics, retail sales and consumer confidence added to the enthusiasm. These positive reports were capped by annualized third quarter GDP growth of 8.2%.

Very accommodative fiscal and monetary markets also fueled equity markets during 2003. The Federal Reserve dropped interest rates to record lows and increased the money supply at unprecedented levels. In addition, the stimulus provided by the Bush Administration through tax cuts and increased spending also gave investors reason to be optimistic.

In Canada, the economic data was less muted. The fallout from SARS, mad cow disease, vast forest fires and the strengthening Canadian dollar all contributed to less than stellar growth. However, the fourth quarter showed some signs of recovery, particularly on the employment and housing fronts.

Most economists are forecasting strong growth in the U.S. economy and a continued recovery in Canada for 2004. In addition, corporate earnings are expected to increase over 2003's levels. GDP is expected to grow at 4.0% and 3.0% in the United States and Canada

respectively. Fiscal and monetary policy are expected to remain very accommodative; especially in light of the upcoming elections in the U.S. The continuing strong performance of the economy and expected increases in corporate profits have set an optimistic tone for equity returns in 2004.

As the following discussion illustrates, PCM is definitely not on the side of the majority on virtually all of today's major investment views.

We are not convinced that the strong growth registered in the latter stages of 2003 and expected to continue into the current year is sustainable. We remain concerned about weak employment growth in the U.S., low capacity utilization rates and unprecedented amounts of debt at all levels of the economy. The very large trade and current account deficits that have led to a rapid decline in the value of the U.S dollar also pose a serious risk. More importantly, our analysis of many companies gives rise to concerns over the quality of earnings, capital structures and valuation levels. Indeed, valuation levels during the previous market bottom did not approach those of earlier bear markets and today's valuations are still considerably above long-term historical averages.

Below we summarize how different our views are compared to the majority:

Majority View	PCM's View
Debt at all time high	Eliminate as much debt as possible
Cash is Trash	Cash is King
Real Estate offers good value	A housing bubble exists
Today equities offer good value	Equities offer poor long-term returns
Bonds are safe	Long term bonds are very risky today
Allan Greenspan is a genius	History will judge Mr. Greenspan harshly

We view last year's strong equity returns in a different light than most. Many argue that last year's rally is the beginning of a new bull market. We place last year's market behaviour in the context of past market rallies in what turned out to be prolonged and severe bear markets. These rallies draw investors back in; then abruptly and without warning turn down again only to break the previous lows. After the Nikkei's large drop in 1990 it rallied thirty per cent before sliding back to set new lows. The Dow also had strong rallies after dramatic drops in both 1929 and 1968 but they too broke down and investors eventually suffered severe losses. [1]

Supporting this view, Fortune Magazine quotes an interesting study:

> **"Grantham and his team have studied every single bubble, all 27 of them… In every *single correction* all the bubble gains were wiped out before a new bull market started; prior great stock bubbles dramatically over-corrected and stayed there for some time."[2]**

We at PCM do not engage in predicting the direction of equity markets. Our purchase decisions are driven entirely by valuation and quality on a security specific basis. Our bottom up process leads us to the same conclusion. We simply cannot find any value. Whenever we encountered such situations in the past, equities went on to produce unsatisfactory future returns.

Most of our peers in the money management industry are astounded when we tell them that our cash balances exceed eighty per cent of our portfolios. Some are outright hostile. Many of those who don't agree with us claim to be value investors and true disciples of Warren Buffett. Our response has steadfastly been that our portfolios are the direct result

[1] Fortune February 2004 Bethany McLean page 36
[2] Fortune February 2004 Bethany McLean page 36

of our bottom up process. In essence our cash position is simply our "fallback" position because we cannot find anything to buy.

You can imagine the smiles at PCM when we read Warren Buffett's most recent letter to Berkshire Hathaway shareholders. Below is PCM's investment equivalent of the Sermon on the Mount:

> **"When we can't find anything to exciting in which to invest, our "default" position is U.S. Treasuries, both repos and bills. No matter how low the yields on these instruments go, we never "reach" for a little more income by dropping our credit standards or by extending maturities. Charlie and I detest taking even small risks unless we feel we are being adequately compensated for doing so."** [3]

Mr. Buffett has repeatedly stated during the past several years that he cannot find publicly traded equities at reasonable prices. Not surprisingly, as of December 2003, Berkshire Hathaway was sitting on more than $31 BILLION of "default positions."

The next time we run into an investment manager or advisor who is espousing the virtues of a fully invested portfolio we'll have thirty one billion reasons as to perhaps why they might want to rethink their position. But of course they won't and can't. To miss out in a rising market is to risk one's very high paying career. Better to risk your capital than a very lucrative income stream! One exception to this behaviour is the investment team at AIM/Trimark led by Patrick Farmer. Patrick's team includes portfolio mangers such as Ian Hardacre who act in their investor's best long-term interest despite the very real short-term pressures of the mutual fund industry.

[3] Berkshire Hathaway Annual Report, Chairman's Letter page 21
Please note: Berkshire Hathaway is an American and buys U.S. Treasury Bills. We purchase Canadian T-Bills for our clients.

We pride ourselves on being different from the crowd. However, we can only stand apart from our peers and have a viable business because of the tremendous support that you, our clients provide. Your trust in us makes each and every one of you stand apart from the crowd!

Vito Maida
March 2004