

“It’s déjà vu all over again.”

Yogi Berra

We started Patient Capital Management in March of 2000. Although more than four years have passed it seems like nothing has actually changed. Then as now equity returns in the previous year had been in the double digits and stock prices were expected to grow to the sky. Then as now enthusiasm for equities was very high. Investors and advisors were very bullish, mutual fund cash positions were very low and market commentators were touting the promise of long-term equity returns.

As well, surprisingly nothing has really changed with respect to the price levels of the major North American indices. They are at essentially the same levels today as in the summer of 2000. The table below provides the broad based North American index levels as of June 30 2000 and June 30 2004. The total return over the four-year period is also provided.

	Table 1		
	June 30 2000	June 30 2004	Total Return
Dow Jones	10,438	10,436	-0.03%
S & P 500	1,455	1,149	-4.4%
TSX	10,196	8,446	-2.7%

As the table above indicates equity indices are slightly below the levels of four years ago and the total return has been negative. This is quite a different outcome than what was expected by the investment industry. Every year the mantra that equities would provide eight to ten per cent long-term returns is repeated. So much so that such returns have become an accepted truism. Four years ago the phrase “equities for the long term” was the

sales pitch and today it is no different. In our view the promise of positive ten-year equity returns is just as likely to be wrong today as it was then.

Let's take what we know today and analyze the June 30 2000 prediction that equity returns would provide an eight to ten per cent compound annual rate of return by 2010. Given that equity returns have been slightly negative over the past four years compound annual equity returns would have to be approximately 17.25% over the next six years in order for the ten-year return beginning in 2000 to reach ten per cent. If we reduce our required rate of return to eight per cent then the compound annual return would have to be about 13.65% over the next six years¹.

We believe that thirteen to seventeen per cent returns are extremely unlikely over the next twenty years let alone the next six! First and foremost as in 2000 equity valuations are substantially above long-term averages. When valuations are significantly above long-term averages long-term returns must necessarily be below the long-term averages! In addition, both inflation and interest rates are rising. These changes in the economy will reduce both profit margins and price to earnings multiples. In the face of such headwinds we find it difficult to understand how future equity returns can produce anywhere near the numbers discussed above. Not surprisingly, today just as in 2000, we believe that equities will struggle to provide even modestly positive returns over the next ten years.

Four years ago the hot topic of discussion was Nortel. Today Nortel still generates much debate. In 2000 we at PCM believed that an investment in Nortel shares was sheer speculation. Our view is no different today but for very different and perhaps even more serious reasons.

¹ For the sake of mathematical simplicity we have assumed that returns have been zero over the past four years As Table 1 shows they are slightly negative.

In June of 2000, Nortel shares were trading at approximately \$120 and at over 100x earnings. This extreme valuation coupled with fundamental concerns about the company led us to conclude that an investment in Nortel was very risky. While we did not purchase the shares we could accept that a serious investor investigating the same facts could come to a very different conclusion than we did.

Today Nortel presents a very different situation in profoundly different circumstances. We believe that any portfolio manager or investment organization that claims to follow a thorough and analytical process should not own any Nortel shares. “Fundamental” investors who now own Nortel shares are potentially guilty of gross misrepresentation and speculation!

Why would we make such a strong statement? The analysis of a company’s financial documents is a basic and very important component of a comprehensive analytical review. Indeed we believe that a company’s audited statements to shareholders are the foundation on which serious investment recommendations are built. As has been well documented, Nortel has not published audited financial reports for some time and previous filings are now under review. Without these financial statements Nortel is impossible to analyze and value. An assessment of the company is sheer guesswork and speculation. As a result, Nortel shares should not be in the portfolios of those claiming to be fundamental bottom up analysts!

Today our portfolios are very similar to our portfolios of four years ago. Our cash positions are very high and the number of securities that we own is very low. Then as now our investment philosophy based on an uncompromising commitment to absolute value, safety and quality was questioned by many. But today there is one significant difference. We have four years of history against which we can be evaluated.

As of the four years our taxable portfolios have returned 5.23% while our non-taxable portfolios have earned 10.43%². These results compare quite favorably with the TSX's return of negative 2.7% and the S & P 500's loss of 4.4%. We are particularly satisfied because we were able to accomplish this performance with average cash balances of more than eighty per cent over the past four years. We want to caution you that such returns will be difficult to repeat over the next four years given the current lack of investment opportunities.

We are excited to announce that Mike Nadal has joined PCM as our Vice-President Private Client Group. Mike along with Gary Sharpe is responsible for introducing PCM to new clients and helping us to grow. Mike has a true understanding of our investment philosophy and has embraced our values with great enthusiasm. We are very fortunate to have Mike on our team. If you are interested in providing a referral or learning more about PCM don't hesitate to call Mike Nadal at 416-214-5761.

Four years ago we promised that we would not deviate from our commitment to absolute value and the preservation of your capital. We also promised that we would place our fiduciary duty to you above all other considerations. Today those commitments have not changed. Gary, Domenic, Mike and I will try to ensure that PCM's philosophy and values will not change over the next four years and the four years after that and the four years after that and the

Vito Maida

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² Performance numbers are based on composite returns and are gross of all fees.

Past performance is not an indicator of future performance.
