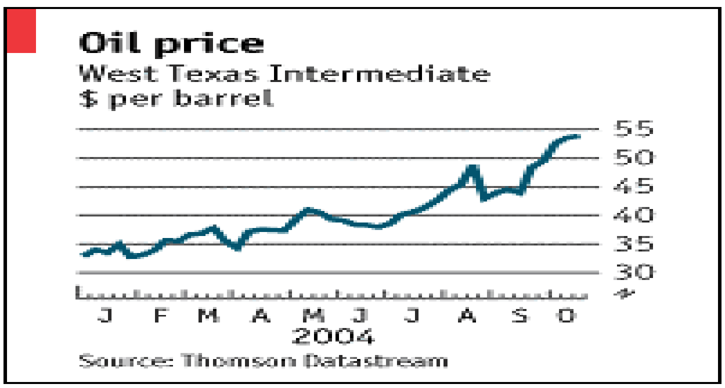
"Black Gold. Texas Tea. Oil That Is"

Theme from The Beverly Hillbillies

The dominant economic development during 2004 has been the price of oil's steady march to record levels. Supply concerns caused by a series of devastating hurricanes in the Gulf of Mexico and Florida pushed prices to all time highs. This supply disruption exasperated existing problems in the oil market caused by production problems in Iraq and Russia. As the graph below indicates, the price of oil has risen from thirty five dollars per barrel at the start of the year to more than fifty dollars per barrel today.

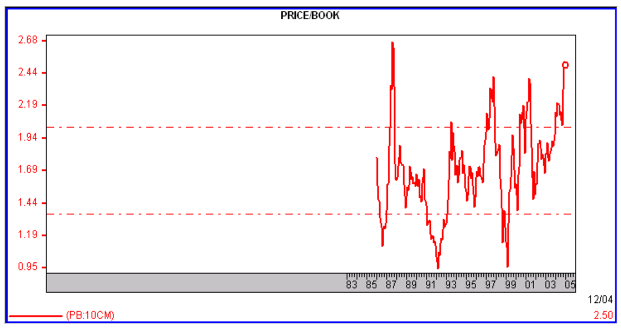


Interestingly, equity markets have taken this dramatic increase in stride. The year to date return as of September 30th for the S&P 500 was 1.51% while the TSX Composite Index earned a return of 6.81%. Investors seem to be overlooking the risk that a continued and sustained rise in the price of oil could produce an unwelcome combination of lower growth, higher inflation and falling corporate profit margins.

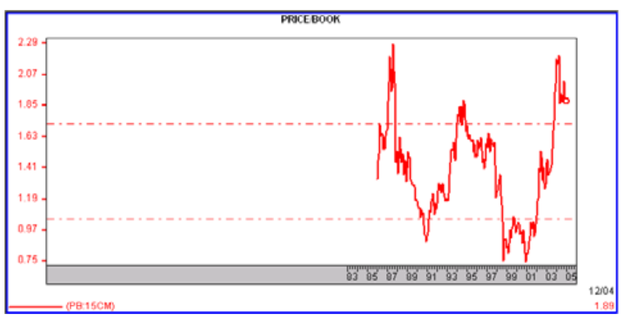
Many would be surprised to learn that the TSX Composite Index is extremely concentrated in just three sectors. Approximately <u>seventy per cent</u> of the TSX Composite Index is comprised of three industry groups; Energy at 18.5%, Materials at 17.5% and Financials at 33%. For those expecting diversification this index is not it! Canadian investors are unwittingly incurring this "concentration risk" through index funds and active money managers who mimic the index.

The following graphs courtesy of C.P.M.S. show the long term price to book ratios for the Energy, Materials and Financial Sub-Indices. The two horizontal lines in each graph indicate one standard deviation from their respective historical average Price to Book Ratios. As the graphs indicate all three industry groups are trading substantially above their historical long-term averages. The Energy and Materials sub-indices are trading above this upper range while the Financial Sub-Index is essentially trading at the upper end of it's long term price to book ratio.

Price to Book of Energy Sub-Index



Price to Book of Materials Sub-Index



Price to Book of Financial Sub-Index

The conclusion is quite startling; seventy per cent of the Canadian market is overvalued! In addition, the valuation of the financial sub-index is entirely inconsistent with the high valuations accorded commodity based businesses. One important reason that shares of financial institutions have performed extremely well over the past several years is the tremendous benefits they derive from declining interest rates. Energy and commodity companies are understandably performing well because of strong commodity prices. Persistently, strong commodity prices will ultimately result in higher inflation and interest rates. <u>Under this scenario financial shares or thirty per cent of the TSX Index is likely to fall.</u> On the other hand, if financial shares are to continue to maintain and/or increase their value commodity prices will have to fall from their record levels. <u>In this case approximately thirty six per cent of the TSX Composite Index is at risk.</u>

Perhaps we are living in a "Goldilocks" scenario where increasing commodity prices are offset by ever increasing productivity thus keeping inflation low. We at PCM have observed that such perfect scenarios eventually come crashing back to reality and that the optimism was truly based on fairy tale hopes.

The above discussion leads us to question one of the founding blocks of modern finance; the efficient market theory (EMT). This theory was formulated in the sixties and became very popular in the seventies. Today it is taught in every finance program. Essentially EMT says that security analysis is a worthless endeavor because all publicly available information is correctly reflected in stock prices all of the time. EMT suggests that this is possible because there are thousands of very smart and very motivated people all looking to profit from some market pricing anomaly. All of this intelligent effort results in security prices that always accurately reflect true value. Attempting to outperform the market is a futile exercise. Indexing is the only appropriate strategy. Just as importantly, the EMT advocates believe that risk is minimized because an index is supposedly broadly diversified.

According to EMT, price and by definition the crowd that sets the price is all knowing. The crowd accurately sets value through the constant repricing of securities. Let's look at a practical example of what EMT implies. At 10:00 a.m. IBM trades at $80.00 per share; thus its value. Five minutes later, this same company selling the very same products is worth exactly $78.00 because that is

where it traded at 10:05 a.m. At 2:00 p.m. this enterprise is worth precisely $77.50! Common sense suggests that this is ridiculous. But this is what the proponents of efficient markets actually believe!

As we discussed earlier, seventy per cent of the TSX Composite Index is comprised of three sub-indices. Most observers would agree that significant concentration in three sub groups is not proper diversification. Thus those who believe in EMT and recommend indexing are caught in an intellectual inconsistency. The TSX Composite Index is not diversified and therefore not an appropriate investment vehicle, yet the market "properly" set the prices that created the current concentration. In its omnipotent wisdom, the crowd has correctly created something that is incorrect!

We have mixed feelings about EMT and all of its implications. On the one hand as members of the profession we are quite embarrassed that the underpinning on which our vocation is based on is so ludicrous. However, as stewards of your assets we are quite happy that the belief in EMT is widespread. What an advantage it is to us that many of our competitors follow a strategy that is fundamentally flawed. If the Toronto Maple Leafs were as fortunate they might someday win the Stanley Cup!

On examining PCM's record the proponents of efficient markets would suggest that our long term returns achieved with substantially lower risk are a statistical outlier. They would argue that such performance is unsustainable. What they don't appreciate is that you, our clients play a significant role in helping us achieve our results. Your long term time frame and focus on the preservation of capital give us the mandate to wait for that perfect pitch. It is this mandate that drives our performance. We do not have to compromise on quality and/or price. We can simply wait until we find high quality investments that provide us with the opportunity to earn a significant return with much lower risk.

With your continued support we look forward to being a statistical outlier for many years to come!

Vito Maida

October 2004