

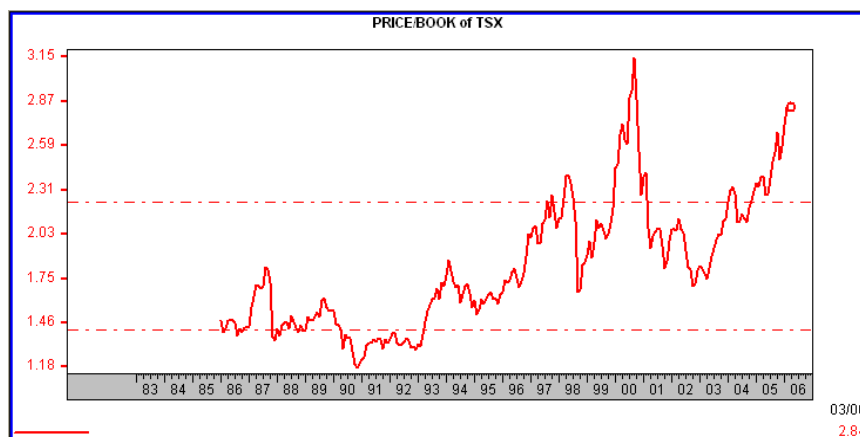
“It was the best of times and it was the worst of times.”

Charles Dickens

The past year has certainly been the “best of times” for those invested in Canadian equities. Canadian equity markets have enjoyed strong returns and have outperformed the U.S. and most other international markets. The best of times have continued in the first month of 2006 with the TSX gaining over six per cent! As we have stated in the past and has been well documented by others these gains have been largely fueled by energy stocks.

In our view the good times have transformed into dangerous times. As the graph below indicates, the TSX’s valuation has topped all previous peaks since 1984 with the exception of the Nortel inspired craze of 2000 and is substantially above its’ long term average!

Graph 1
Long Term Price Book Value of TSX¹



The overvaluation is even more evident when trying to find specific undervalued securities. In a Canadian universe of approximately seven hundred publicly listed companies with a

¹ Source: C.P.M.S.

market capitalization of greater than one hundred million we could only find **thirty eight** candidates with a debt equity ratio of less than one and a price to book ratio of less than 1.2x. During more typical market conditions this group would yield approximately two hundred prospects. In depressed markets this screen would provide more than four hundred possible investment opportunities.

The Canadian market is also more expensive than the American equity market; particularly when comparing the two major components of the TSX to their counterparts south of the border. As illustrated in Table 1 below, Canadian bank and energy shares are far more expensive than their U.S. comparables.

Table 1
Valuation of Canadian vs. U.S. Comparables

	P/B	P/E	Yield	
Average Canadian Banks	2.90x	16.52x	2.90%	
Average U.S. Banks	1.57x	12.22x	3.90%	
	P/B	P/E	Yield	P/CF
Average Canadian Energy	4.88x	21.95x	0.70%	10.97x
Average U.S. Energy	3.16x	14.13x	1.88%	7.07x

These expensive valuations will inevitably lead to the “worst of times.” Excessive valuations always lead to substantial losses. History tells us that this outcome is a certainty; the only uncertainty is the timing of such losses.

These are also the “worst of times” for many value investors. Predictably they have sold their energy positions “early” or have avoided the sector for some time based on the belief

that the price of oil is unsustainable at current levels. Predictably, like us they have underperformed the TSX.

And predictably most of these investors have encountered severe criticism. Some are concerned for their careers, some are worried about losing clients and others have had their competence publicly questioned. The irony of the current situation is that some portfolio managers were essentially “run out of town” for having made substantial investments in oil and gas, gold and metal companies when these shares were literally trading for a fraction of today’s prices!

It is usually the same group of financial advisors, pension consultants and non-investment executives that provide this chorus of angst when competent and careful value oriented investment professionals are temporarily underperforming due to a contrarian stand. The very same group who originally recommended or supported these managers because they supposedly believed in the style and process! Predictably, it is always the clients who suffer the serious consequences of these “buy high sell low performance chasers.”

On January 31, 2006 Allan Greenspan retired as Chairman of the Federal Reserve Board. Mr. Greenspan has been lauded as perhaps the greatest Federal Reserve Chairman ever. Many would argue that under his leadership we have experienced the best of economic times.

We view his tenure somewhat differently. In our opinion, Mr. Greenspan allowed several investment bubbles to grow to dangerous levels and then aggressively liquefied the financial system to avoid serious economic consequences once the bubbles burst. In turn, this excessive monetary stimulus has lead to a broad based inflation in virtually every asset class; the current housing bubble being the most dangerous. Perhaps, more importantly Mr. Greenspan’s bailouts conditioned investors to believe that the consideration of risk is of secondary importance when making investment decisions.

Mr. Bernanke, the new Federal Reserve Chairman, inherits the results of his predecessor's policies. Some of the most notable being unprecedented U.S. trade and current account deficits, an overvalued real estate market, billions of dollars in risky and unregulated hedge funds and pent up inflationary pressures. All of these issues are magnified by record levels of consumer and government debt in the United States. Thanks to Mr. Greenspan the new Federal Reserve Chairman may eventually come to preside over the worst of times!

At Patient Capital we are indifferent to the times. We are solely focused on preserving your capital and making long term investments in high quality businesses at a substantial discount to their true worth. It is this approach and your support that always makes our experience at PCM the best of times!

Vito Maida

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