

What a bounce!

From the depths of despair hit on March 9th of this year equity markets have rebounded by more than thirty per cent. Up until then investors were concerned that we were heading into a financial abyss led by the banking industry. A severe recession was a certainty and the possibility of a depression was quite high. At one point fear was so rampant that returns on T-Bills were negative! Some were paying for the right to own government securities in order to protect their principle.

As is the case in such pessimistic environments it doesn't take much to turn investor sentiment around. Citibank stated that they expected to be profitable in the first quarter. As a result, financial institutions were deemed to be healthier than previously thought. Better than expected news on employment, consumer confidence and profitability also added to the positive mood. Investors once again were willing to take risks and equities began their strong and sharp rebound.

A common question today is where do markets go from here? Those arguing for a further rise point out that valuations are more attractive than they have been in several years, interest rates around the globe are at record lows and that there is a tremendous amount of cash on the sidelines waiting to be deployed. The more cautious suggest that a pullback is likely after such a spectacular run-up. In addition, they argue that the economy and corporate earnings are much weaker than expected and as a result another large decline is in the offing. When it comes to predicting short term market direction our record is as reliable as a coin flip. However, if we had to make a guess we would err on the side of caution at this point.

We are willing to make one prediction; over the next five years long dated government securities will likely provide negative real returns. In our view, "safe" government instruments are some of the riskiest investments available. Today three to five year

Government of Canada bonds are yielding approximately 1.75% while bonds with a maturity of ten years or more are yielding 3.75%. These rates are substantially below long term averages and imply very little if any inflation in the future. We believe that the odds are very much against such a scenario.

Central banks and governments around the globe have applied fiscal and monetary stimulus to their respective economies. The amount and aggressiveness of such action is unprecedented. We believe that the natural outcome of such a massive global stimulus is likely to be an inflation rate that will be well above recent experience and perhaps substantially above long term averages. Under this scenario interest rates will rise significantly and because fixed income values decline as interest rates go up the potential for the loss of capital in government securities is quite high over the next several years.

Many are predicting a dramatic decline for the U.S. dollar due to the extraordinary economic measures taken over the past several months to avoid what some believed to be a possible collapse of the U.S. and global economies. Those espousing this belief point to the multi trillion dollar government bailouts and spending leading to the consequent deficits. We do not share this dire view for the U.S. dollar. Virtually every major economy in the world has implemented the same deficit based policies. As a result, the U.S dollar should remain in the same approximate trading range relative to other major currencies as it had been before this crisis began. Please note that we are not suggesting fluctuations in the value of the U.S. dollar; we just don't see a massive collapse.

Recently we were asked to provide a detailed analysis of our security selection for our High Net Worth Portfolios. We analyzed every investment (excluding T-Bills) that we made from our inception in March of 2000 till April 30th of this year. We simply took the return of our investment over our holding period and compared it to the TSX or S&P return over the similar holding period. The results surprised us. Below is the summary of our analysis:

PCM Security Selection Relative to Benchmarks

March 31, 2000 to April 30, 2009¹

% of Securities Outperforming Benchmark	80.00%
Average Outperformance Relative to Benchmark	83.62%
Mean Outperformance Relative to Benchmark	30.01%

Proponents of efficient markets and virtually every finance professor would suggest that the above results are not possible. But the evidence is irrefutable and the time frame long enough to suggest that these results are not a mere coincidence. Why then has PCM been able to achieve these results?

We believe that our achievement is not based on a proprietary investment process but rather on three basic principles that we have strictly followed; focusing only on our fiduciary duty, being conservative and minimizing our activity.

Since inception our primary goal has been to behave as fiduciaries on behalf of our clients. To us this principle has meant concentrating entirely on the investment process with little regard for the implications to our business growth. We are not afraid to be extremely different from our peers or an index; nor are we concerned with short term performance. Consequently, we are able to make only those investments that truly meet our criteria for quality and value without compromise. Just as importantly, we are willing to wait a very long time in order to find investments that meet our very high standards and then wait for their intrinsic value to be recognized. The fact that we can wait for and choose that perfect “pitch” increases our odds of success dramatically!

¹ Based on Representative Account
Before Fees and Expenses
Past Performance not Indicative of Future Performance

We are very conservative, highly skeptical and always try to stack the probabilities in our favour. We attempt to purchase our investments at a substantial discount to intrinsic value. As well, we steer clear of “red flags” and complexity. If we encounter an issue that makes us uncomfortable we simply walk away and look for another opportunity. Our large margin of safety combined with our focus on staying out of trouble considerably increases our likelihood of success.

Finally we don't make a lot of decisions. The record presented above is based on thirty investment decisions over nine years. That is an average of 3.3 purchases per year! In direct contrast to the notion of diversification we believe that the fewer decisions that we make the more likely we are to be right. This inactivity affords us the time to be thorough, thoughtful, and careful and gives us the confidence to take large investment positions. Then because each investment is a large portfolio position the returns are quite substantial when our investment thesis materializes. At PCM less is indeed more!

To summarize we have been able to achieve over a long period of time what others have found very difficult to do by following three very simple principles; by always acting as a fiduciary, by being conservative and through limited activity.

To end on a personal note we at PCM would like to congratulate our long time friend Keith Graham on starting his investment firm, Rondeau Capital. Keith is that rare individual who embodies integrity, intelligence, humility and good judgment. We wish Keith the best of luck and are quite confident that Rondeau Capital will be very successful!

Vito Maida

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