"It's like déjà vu all over again."
Yogi Berra

It has happened again!

Global central banks have created another bubble! The easy monetary policies and near zero interest rates of the past two years have increased the appetite for risk. The lack of interest income has pushed many investors to attempt to replace this income with capital gains. In addition, low interest rates have encouraged speculators to borrow money and invest the proceeds in the hope of making an interest rate spread or earning capital gains. As we have seen in the past, these situations can only end badly.

The latest manifestation of this bubble is the initial public offering of LinkedIn, a social networking site targeting professionals. On the first day of trading the shares more than doubled! What is truly astounding is the valuation at which these shares trade at.

LinkedIn generated a modest profit of $15.4 million last year (Exxon Mobil earns more than $82 million per day!) but is valued at almost nine billion dollars. These figures translate into a price/earnings ratio of 584x! We can only imagine what price/earnings ratio Facebook would trade at if it were a public company. A price/earnings ratio of 1,000 would not be out of the question under today's circumstances.

Fast growing social networking companies are not the only sign of excessive valuation in today's equity markets. Below are other examples that point to excessive risk in the current environment:

- **Small capitalization stocks have outperformed medium and large capitalization stocks by a wide margin**

- **Highly levered companies and/or generally recognized low quality companies have far outpaced high quality companies**

- **High quality value stocks and value managers have underperformed by substantial margins over the past twelve to eighteen months**

- **Companies that report earnings above expectations are traded up sharply while those that report disappointing results are sold down irrespective of valuation**

- **The demand for income is unprecedented and investors are flocking to virtually any income producing instrument with little regard to quality**

Canadian assets have not been immune from this excessive risk spurred by easy money and low interest rates. Speculators, momentum investors and those seeking <u>perceived</u> safety irrespective of valuation have found us. Ironically, it is our very strengths that have put us in this precarious position. Canada's reputation as a stable and safe country to invest has become a magnet for international investors over the past two years. International enthusiasm for Canada has driven prices to the point where we strongly believe that Canadian assets are at substantial risk and likely to suffer a serious setback at some point.

This "love affair" with Canada has resulted in two potentially troublesome events. Real estate prices in Canada's major cities have escalated sharply. Vancouver now sports the third most expensive housing market in the world and housing costs across Canada as a percentage of total income are at the highest level ever as are debt to income ratios. Most reasonable observers are suggesting at a minimum that buyers should be very careful while others are predicting a serious correction in Canada's real estate market.

The second risk is in our equity markets. As we have discussed in the past, the Canadian market is dominated by oil, precious metals and base metal companies. In our view the underlying commodity prices of these resource based companies are at unsustainable levels. Should commodity prices drop to "normalized" levels a severe correction in the TSX is inevitable.

The combination of falling real estate prices and dropping equity markets will result in a significant decline in consumer confidence and a slowing economy as Canadians see their two most significant investments decline in value. Under this scenario international investors will likely stampede out of Canadian assets compounding the problem and causing a drop in the Canadian dollar.

At this point in time, the above outcome seems unlikely. However, with little variation we can look back at 1974, 1981 and 1989 as historical precedents. In all three cases the TSX and Canadian asset prices were propelled upward by rising commodity prices and foreign investors. And in all three cases; real estate, equities and the Canadian dollar suffered severe corrections.

It is not surprising then that we do not own any resource companies, that our cash balances are increasing as we sell investments that reach our target prices and that the few new purchases that we have made have been in the United States. In addition, we strongly recommend that debt reduction should be a priority for those carrying large debts.

We have now experienced three periods over the past eleven years where our views have turned quite negative. In each scenario we remained unwavering in our conviction and discipline. A few observers have attributed this steadfast approach to our analytical strengths and many more to my "stubbornness." However, the reality is that there are many investment managers who share our philosophy, many who are very strong analysts and many who are very intelligent, hardworking and diligent. Yet PCM's long term

performance and risk profile since inception are superior to almost all other investment organizations. There is no magic formula or secret sauce.

We at PCM are very fortunate that you allow us to implement a long term strategy that protects and preserves your capital while providing the opportunity to take advantage of attractive investments as they arise. This mandate is very rare and quite valuable in the investment industry. The process of waiting, buying, selling and then waiting until attractive investments appear again is how true long term wealth is patiently created.

The truth is that you, our clients, are our "investment edge" and competitive advantage because you give us the privilege to do what we do.

Thank you!

Vito Maida
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