

*“The more things change the more they stay the same.”*

*Anonymous*

*The tragic events of September 11, 2001 have shaken North Americans to the core. Our belief that we are immune from much of what others in the world have been living with for some time has been shattered. In the aftermath of the attacks on the World Trade Center and the anthrax scares we are naturally angry and fearful. Our collective conscience instinctively understands that our world has changed. It is now a far different place.*

*We at PCM have observed with very mixed emotions the events that have unfolded. As citizens we are deeply saddened by the tragic loss of life and concerned about the long-term impact on our society that terrorism on our soil will have. However, as fiduciaries of the assets that you have entrusted to us we are quite sanguine. Our investment philosophy and process helps us to withstand the most difficult of events; in essence our investment philosophy is designed with the worst-case scenario in mind. Unfortunately, such a scenario came to pass.*

*In the days following the September 11, 2001, attacks professional and non-professional investors alike were quite fearful. The business press was inundated with pundits and commentators who stated that the world had changed and consequently that their investment stance and approach had also changed. A variety of factors had changed; risk had increased dramatically, the economy*

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*would slowdown or global conflict was likely to ensue. Portfolios had to be revamped for yet another new paradigm.*

*We and you our clients were not concerned about the portfolios. As you are aware, depending on portfolio objectives, we were eighty to ninety-five percent cash. In addition, the businesses that we owned were unassailable due to their superior balance sheets and strong operating characteristics. We could never have predicted the tragic events of September 11, 2001; however, due to our investment philosophy we were prepared.*

*In the days following the initial terrorist attacks we were focused on deploying our cash in companies that met our criteria both on a fundamental and price basis. We were ready to do so with confidence because of the strong underpinnings of our process. We only make investments in attractive companies with exceptional records of strong performance at prices that have a substantial margin of safety. While extremely uncomfortable about the circumstances that led to the potential buying opportunities we were nonetheless quite comfortable that our potential investments were safe and that our purchase prices would over the long term provide a substantial rate of return. When equity markets reopened we were disappointed to see that our purchase orders were not filled because share prices did not reach our buy targets.*

*Indeed after bottoming in late September markets have surged ahead quite dramatically. Returns from September's lows are approximately 10%, 15% and 30% for the TSE 300, Dow and NASDAQ indices respectively. Bullish market*

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*pundits now point to low interest rates and very large infusions of liquidity by the U.S. Federal Reserve as justification for increases in equity prices and continued high valuations. They conveniently ignore the constant stream of negative news; increasing quarterly losses, increasing bankruptcies and increasing layoffs. They point to a short recession and strong recovery in the second half of 2002. They conveniently forget their earlier predictions of no recession and strong economic growth in the second half of 2001 as they assuredly make their new cheery forecasts.*

*Our view is that the expected robust economic recovery reflected in current equity valuations is premature. Our analysis of individual companies and discussions with managements across several industry sectors indicate that business conditions are getting more difficult; managements are preparing for tough times! Our understanding is that more layoffs will be announced in January. Continued job losses coupled with high personal debt levels do not bode well for a consumer led recovery in 2002.*

*In addition, the financial excesses of the late nineties were amongst the most spectacular in history. Extraordinary investment in capital; particularly in the high tech industries was matched by equally extraordinary valuations in equity prices. History suggests that economic recovery after a financial bubble bursts is anemic and slow. Perhaps Warren Buffet, Chairman of Berkshire Hathaway and world renowned investor was looking at such historical precedents when he wrote to his managers: "I'm sure we are in a recession, probably a relatively deep and extended one..." Surprisingly the media, which usually hangs on every*

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*word uttered by Mr. Buffet paid scant attention to this statement. It would have been interesting to see the financial press coverage had Mr. Buffet declared the start of a new bull market!*

*Rather than relying on subjective comments we can turn to our analytical framework for guidance. In it's most basic form equity valuation is uncomplicated. There are three variables; expected earnings (E), the discount rate applied to those future earnings (R), and the future growth rate (G). The discount rate (R) is made up of two components; current interest rates (I) and a risk premium (rp). Thus the formula is:  $\frac{E}{(I + rp) - G}$*

$$(I + rp) - G$$

*For example, a hypothetical equity with forecast earnings of \$1.00 per share expected to grow at 5% in an environment where long term interest rates are 6% and a risk premium of 4% would be worth \$20.00 per share.<sup>1</sup>*

*If we use this framework to evaluate today's market we can assess whether the current optimism is warranted. Let's start with earnings. Virtually every analyst agrees that on aggregate earnings will decline in 2002. Secondly, we must determine the discount rate. Long term interest rates have fallen by about two percentage points. However, the risk premium has increased due to the tragic events of September 11 and uncertain climate. Let's assume that the risk premium should increase by one per cent. Finally, we must address the growth rate. Again even the most optimistic would be hard pressed to suggest that future*

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*growth will be slower than it has been in the past. Let's assume future growth is slower by one per cent.*

*Let's go back to our example. The \$1.00 earnings estimate now falls to \$0.95. The discount rate declines to 9% while the growth rate drops to 4%. Using these assumptions our equity is now worth \$19.00 per share.<sup>2</sup>*

*Applying the same process to today's market sentiment leads us to be much more cautious than others. Future earnings are expected to decline and grow at a much slower pace. While interest rates have declined the increased uncertainty leads to a higher risk premium. Thus just like the value of our hypothetical equity example market optimism should come down.*

*We at PCM will not deviate from our stated philosophy of focusing on the preservation of your capital through the purchase of attractive businesses at prices that provide superior returns over a long period of time. For us it is very true... the more things change the more things stay the same.*

**Vito Maida**

**November 2001**

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<sup>1</sup>  $\$1.00 / ((.06 + .04) - .05) = \$ 20.00$

<sup>2</sup>  $\$0.95 / ((.04 + .05) - .04) = \$ 19.00$

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