"The first rule of investing is never to lose money. The second and third rules are not to forget the first one."
Warren Buffett,
Chairman, Berkshire Hathaway

The bull is back!

It's true. Just ask your local broker. Listen to the cheery business commentators on the television and radio. Better still ask your boy genius fund manager; he too believes that it's true. Listen closely … all you will hear is bull.

Even though GDP growth for the third quarter was reported to be an astounding 7.2% we at PCM aren't buying into the bullishness. We believe that such a torrid pace is unsustainable and has been fuelled by unprecedented monetary and fiscal stimulus, tax rebates, and mortgage refinancing.

We remain very cautious and continue to be quite concerned with four key fundamental issues facing the U.S. economy. Unemployment continues to be quite weak. Jobless claims continue to hover at the 400,000 level and the unemployment rate recently touched a nine-year high of 6.4%. Should these jobless levels persist, it is likely that consumer spending will slow dramatically at some point in the future.

Capacity utilization remains low by historical standards at approximately 74%. An increase in capital spending will remain elusive until utilization rates show substantial improvements. Consumer and corporate debt levels are both at all time highs. In particular, household debt is at a dangerous point and debt service costs have been kept at manageable amounts only because interest rates are near all time lows.

Finally, true economic profitability (as opposed to accounting profits) is stagnant. Cash earnings have not been growing. Indeed two prominent business publications recently commented on this very topic and confirm what we have been discovering in our analysis. The September 15, 2003, issue of Fortune noted that corporate income reported to the IRS has remained essentially flat while operating income as presented to shareholders has grown sharply. In addition, twenty five per cent of the improvement in second quarter profits was due to lower depreciation costs.[1] In the same vein Business Week stated in it's October 20th issue that "while the net income of the S& P 500 doubled from the end of the recession through the second quarter, operating cash flow rose just 3.8%"[2]

In a nutshell, we believe that high debt levels combined with potentially declining cash flows due to lower corporate and consumer spending do not bode well for sustained economic growth and could well lead to serious setbacks for the economy and equity prices in the future.

Investors seem to be overlooking the above concerns in the expectation that economic conditions and corporate profitability will continue to improve dramatically in the future. Valuation levels have been driven once again to lofty levels. The trailing P/E for the S&P 500 is more than twice the historical average price-earnings ratio of 15. The average share price for the companies that PCM monitors carefully is more than 200% above our targeted buy price. We strongly believe that these very high valuation levels coupled with the economic risks discussed above present substantial risks for equity markets.

Worse still, investors seem to be returning to pre-2000 behaviours. Margin debt is higher today than it was prior to the market peak in March 2000, stock prices are being bid up on suspect earnings reports and unprofitable companies with questionable business models

[1] Fortune September 15, 2003 page 38, Anna Bernasek
[2] Business Week October 20, 2003 page 16, Peter Coy

are again valued at stratospheric levels. Highly leveraged and low priced shares have shown the greatest percentage increases; often on very low volumes.

Market participants are once again abandoning any fear of risk in light of all this bullishness. Ever the contrarians, we believe that it is at times such as these that it is prudent to focus on risk. Thus, we want to address the topic of risk in the discussion below.

Academics view risk in terms of volatility or fluctuations of monthly prices or returns over some relatively short period. According to this view, the greater the fluctuations in a share price or a portfolio the greater the risk. This volatility or risk is minimized through diversification. In its simplest terms, this principle is the underpinning of modern portfolio theory.

This concept is taken one step further and compares the volatility of a particular share price to its relevant index. The term "beta" is used to capture this concept. A high beta stock provides a higher return than the index when the index is on the rise and declines more than the benchmark in a falling market. For example, a beta of 1.5 means that if the market increases by 10% the stock's return will be 15%. Conversely, if the market dropped 10% then the same share would post a negative return of 15%. Low beta stocks or portfolios behave in the opposite manner. A beta of 0.75 implies that the returns would be 75% of a rising index but declines would only be 75% of the market during falling equity prices.

We believe that this definition of risk is ridiculous! We define risk as the probability of the <u>permanent loss of capital.</u> In our view, short-term share price fluctuations do not have any relationship to the inherent risk of an investment. We believe that two primary factors determine risk; the fundamentals of the underlying business and the valuation at which the shares were purchased. Our very detailed analytical process concentrates on these two

issues. In essence, we minimize risk not through excessive diversification but through a thorough understanding of each investment.

We focus on the preservation of your capital and ours through our detailed analytical process, which helps us to understand all aspects of the business. We invest only in those companies that we understand. Our preferred investment vehicles are businesses that have been in operation for a long time with easily identifiable products, services and brands. The quality of the people managing the enterprise is also very important to us. Finally we will only invest in companies with strong balance sheets and sustainable cash flows.

Investments with the merits discussed above mitigate risks in several important ways. They are not subject to product obsolescence or threatened by new technological developments. Businesses that have been operating for several years have a record of performance that can be analyzed. The characteristics of the business and management's decisions can be scrutinized over a meaningful period of time. Excellent management teams can be relied upon to manage the business properly, adapt to challenging situations and always act in the best interests of shareholders. Experience and observation has taught us that investing in companies with sound financials goes a long way towards reducing the risk of permanent loss of capital. Companies with such characteristics can withstand macro economic, industry or company specific shocks much more readily than weaker competitors.

The second and equally important step in minimizing risk and preserving capital is determining an appropriate purchase price. We are uncompromising on this issue. Entry prices are critical in generating future returns and just as importantly in preserving capital! We spend a significant amount of time calculating the intrinsic value of a potential investment. Once we calculate a company's value, we will only purchase the shares at fifty to sixty per cent of this figure. For example, if we believe that a business is worth thirty dollars per share our purchase price would be in the fifteen to eighteen dollar range.

This substantial discount provides a significant "margin of safety" should the business fundamentals and/or management disappoint us. In such cases we have usually been able to exit the investment with our capital intact.

Perhaps the least understood risk is what my partner Gary refers to as "behavioural risk." In short, the risk that the client and/or the money manager do the wrong thing at the wrong time because short-term performance is lagging. Numerous studies show that while long-term equity returns have averaged approximately eight per cent, individual investors in mutual funds have earned a return of roughly three per cent. This sub-par performance is due to the fact that most investors chase returns, switching to the hottest short term performing manager just as the performance is about to lag.

"Behavioural risk" in a money management organization manifests itself in several ways and in most cases is a direct result of the conflict between a money manager's fiduciary duty and the obligation to its shareholders. Investment organizations will often change course in either personnel or in investment philosophy, usually near the bottom, in an attempt to protect their business. Many money management firms will also offer products that are quite risky in order to attract assets to the latest trend. Ultimately the consequences of the counsellor's behaviour are unwittingly borne by the client. Performance is dramatically lower than it would otherwise have been or the client suffers tremendous capital losses as the new product proves to be highly flawed. The recent scandals in the U.S. mutual fund industry are a perfect example of investment firms placing their own interests above their fiduciary responsibility to clients.

While we cannot control your behaviour, we can control ours. PCM was founded on the simple principle that an investment firm's duty is to act first and foremost as a fiduciary and steward of the capital entrusted to them. We have attempted to embed this principle in three important ways. PCM partners and employees must invest their capital in exactly the same way as client portfolios without exception. In addition, our stated goal is to have very

low costs. We never want to be in a position where we are tempted to compromise our investment philosophy because we need to cover our overheads. Finally, we also choose our clients very carefully. We do not want clients who do not truly share our philosophy. Such clients often prove to be a serious distraction and if large enough, a source of temptation to compromise in order to satisfy short-term concerns.

We strongly believe that focusing on our fiduciary responsibility will greatly reward you, our clients and help PCM to grow. Should we ever stray from this fundamental principal close us down… and that's no bull!

Vito Maida
October 2003