"In the short term the stock market is a voting machine and in the long term it is a weighing machine."

Benjamin Graham

The Intelligent Investor

It finally happened.

When you look at the value of the equity investments in your portfolios as of June 30, 2008 you will notice that some holdings are slightly below cost and two positions are approximately twenty five per cent below our average purchase price. While we view these temporary declines as quite normal over the course of our investment time horizon most of you have not experienced such declines as clients of PCM.

We want to highlight this issue because almost all of our past equity investments seemed to increase in value shortly after we purchased them. This anomaly always concerned us because we thought that it could lead to the unrealistic expectation that PCM would never experience declines in the prices of the shares that we own. We have always commented that our "bottom picking" was pure coincidence and quite unusual. Because of the contrarian nature of our value based philosophy we actually expect that our investments will decline in price after our initial purchase. That is why we buy a small initial position and then purchase more as the price declines until the investment meets its target weighting; usually five percent.

We constantly talk about and focus on the preservation of capital. Given recent experience and what we expect may occur in the future we thought that it might be useful to review the whole concept of the preservation of capital.

We view ourselves as long term owners of businesses. Our objective is to purchase these businesses at a substantial discount to what we believe them to be worth; often referred to as the intrinsic value. Healthy and sound businesses tend to grow their intrinsic value over time at an average rate of approximately five per cent per year.

The daily quoted market value of the security is only important to us because it provides a reference point in relation to the intrinsic value of the underlying enterprise. A business whose shares are trading substantially below their estimated worth would be a candidate for purchase. Thus assuming that the business has a sound competitive position, is financially strong and that the initial estimation of intrinsic value was based on realistic (conservative in our case) assumptions then a decline in the share price should be viewed with glee. Such opportunities offer a chance to purchase more of an undervalued security and earn an even higher rate of return. We refer to these situations as "qutotational losses." Over time the share price will recover to the business' intrinsic value and above the average cost of the investment. Ultimately patient investors will be rewarded.

<u>The permanent loss of capital is entirely different. The share price decline will never get back to its original cost base.</u> This occurs for one of two fundamental reasons. The most common reason for losing capital is the purchase of very good companies at extremely high valuations. This tends to occur when a mania or market bubble develops in an asset class or industry sector. One such example is the Internet Bubble earlier this decade. For example, Cisco Systems the dominant supplier of communication tools for the internet then and now sold for over $77 per share at its peak. This price translated into stratospheric valuations. The P/E ratio was over 100x and the price to sales ratio was 36x.

Today the shares trade at approximately $21.00 per share and a P/E multiple of 13.5x. It is unlikely that investors who purchased the shares at their peak will ever get all of their money back. This is a permanent loss of capital.

The second reason for the permanent loss of capital is the purchase of shares where the underlying business is unsound or extremely risky. Purchase of start-ups, concept companies or "revolutionary businesses" are examples of the latter. These investments are mere speculations. It is very difficult to find the next Microsoft. Purchasing a lottery ticket would provide similar odds of success!

Investments in companies that have far too much debt, aggressive or fraudulent accounting practices and dishonest managements can lead to unrecoverable losses. Other company specific reasons for an investor's loss of capital may be management's inability to implement an effective strategy, ill conceived acquisitions or the sudden obsolescence of a key product or a steady erosion; to name a few.

We believe that our approach helps us to avoid the permanent loss of capital. As we have discussed in the past this intensive process includes:

- **a detailed analysis of the company's financial structure, accounting and cash flows**
- **a thorough assessment of the company's competitive position, potential risks and long term returns**
- **stress testing financial models for worst case scenarios**
- **the conservative estimation of a company's value and the purchase of the shares at a forty to fifty per cent discount from this value**

In addition we will not invest in companies that do not have a long term operating history, "concept companies", newly listed companies and companies that we do not understand.

Once we make an investment we are very patient. We do not react to price movements or market turbulence. Our entire focus is on the continuous assessment of the company's fundamentals and intrinsic value. We view the knowledge gained through our careful analysis and time as our shield against capital losses.

Today's equity markets are turbulent. The Dow Jones Industrial Average fell more than ten per cent in June; the largest monthly decline in more than fifty years. The credit crisis

is deepening and spilling over into the economy. This past week banking regulators shut down a large California based bank and the U.S. government essentially bailed out Fannie Mae and Freddie Mac. Investors are spooked. We expect the volatility and worrisome news to continue.

As we had hoped these investor fears have provided us with some investment opportunities. Indeed we have invested some of our capital in what we believe to be very strong companies that offer the potential for excellent long returns. Should this downdraft continue we will likely find more investment opportunities to invest our remaining seventy per cent cash balances and "average down" on some of the companies that we do own. Consequently, you should expect to see "quotational losses" and perhaps a negative return for a period of time. Despite our previous experience we cannot pick the bottom nor are our investments likely to be immune from a severe market correction. During this process we wouldn't say "don't worry be happy" but you can rest assured that our philosophy and discipline will not change and that our personal funds are invested in virtually the same manner as yours.

We recognize that volatile markets and dour economic headlines raise questions and concerns. Over the next little while we plan to contact each of you to answer any questions that you may have. We pride ourselves on the fact that our clients are extremely comfortable. We want to make sure that you continue to "sleep at night"!

Vito Maida
July 17, 2008