Rapport

Bear With Me

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MAY 2007

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Have you ever stopped to consider what it would be like to live your life with a black cloud hovering above your head, threatening to put a damper on every day? Or, how about the high and mighty who, once in the chips and adored by everyone, find themselves out of sorts and without acclaim. The world is full of such stories. They teach us that losing track of terra firma and ignoring old friends can be devastating when luck runs out. There are more than a few amongst us who wish that someone would give them a second chance to prove themselves. Many investment community stars fall from grace, their reputation damaged beyond repair. I believe the hedge and private equity fund promoters and their investor clients are about to get their hats handed to them. This is how I read the tarot cards.

LIFE IN THE FAST LANE

About ninety-five out of a hundred of us procrastinate, fifteen to twenty percent being chronic offenders. While many investors are known to dilly-dally about making a decision to buy or sell, it is human nature to go for the sure, short-term gain rather than hold on in the hope of a much superior longer-term reward. Insider trading is not an inherently bearish signal, as plenty of executives regularly exercise options and dispose of shares for estate planning purposes. However, in cases where the practice becomes widespread, investors are advised to ask why. More stringent disclosure requirements have meant fewer adjustments for unusual charges and write-offs that in the past had been a method to make matters appear to be better than they truly were. Nonetheless, one should continue to question the validity of quarterly and annual financial performance statements, as some misguided executives have a habit of spinning the numbers in an attempt to at least match or exceed per-share guidance and investor expectations. They do so by postponing capital investments, deferring maintenance costs, and giving customers an extra incentive to buy more than they would otherwise do before the end of the reporting period, or by simply low-balling estimates to begin with. Such practices are a sign of impending trouble, as the misrepresentation of the truth will eventually be uncovered at great cost to the misled shareholders. Therefore, one would be smart to seek out a second opinion in the hope of investing in trustworthy enterprises with objective sponsorship.

Globalization and new technologies have made business conditions more competitive, and a lot less predictable. Though in a position to retire all outstanding debt, many corporations have instead chosen to keep ever-increasing cash reserves on hand, as though

for a rainy day. This trend has not escaped the notice of investors who would rather the benefits of a more generous dividend and payout ratio, a meaningful buyback programme and/or complementary acquisitions, aiming to realize a higher share price over time. Otherwise the hedge fund and private equity types may come a-calling, buy the outfit at a relatively cheap price and get the job done to their advantage, and not that of the individual and institutional investors.

Even though it has become increasingly difficult to pick winning investments, one proven measure is the private market value. Though more an art than a science, it seeks to determine the amount a buyer might pay for a company in an acquisition. Arriving at the precise PMV is extremely challenging, as it requires making an educated guess about the dollar value of its underlying assets, the calculations varying from one sector and company to another. Nonetheless, this type of reasoning has become an integral part of day-to-day stock-picking strategy aiming to enhance overall portfolio returns.

PITY THE SMALL INVESTOR

In the roaring 1990s, they used to call the gunslinging mutual fund managers “cowboys.” With boundless faith in growth stocks, they willingly paid ridiculous sums for almost any hot new name, a go-for-broke strategy that succeeded handsomely at the time. Then, as in a classic tragedy, hubris took its toll. The dot-com boom’s subsequent demise devastated prices. Investors, once zealous to get aboard the high-performance bandwagon began jumping off, suffering great losses when they cashed out. Some of the investment managers were eventually called on the carpet for allowing wealthy clients the added privilege of market timing – quick-and-dirty in-and-out trades that hurt the returns of the less-well-off souls caught in the crossfire – akin to the frowned-upon practice of backdating stock options. Proof again that the poor tread lightest on the earth, the greater a man’s income, the more resources they control and the more havoc they wreak. Unfortunately, it continues to be quite difficult for those in high places to give up on the presumptuous idea they deserve more than their fair share.

With the mavericks and their huge bets of yore gone, and the regulations tightened, the focus has switched back to value, favouring companies with tightly knit strategies and thorough research analyst coverage. Buying beforehand is no longer seen to be the way to riches. Nonetheless, risk profiles are still not as safe as they once were, mutual fund fees remain extravagant, portfolio turnover rates excessive, few investors convinced those with disappointing performance numbers are likely to find their way in the future. Pity the small investor who is led to believe otherwise, for they will never get their just due.

THE THIN EDGE OF THE HEDGE

Investing is a game of averages, nobody bats 1000. But, if your judgment is astute and gains far outweigh losses, there will eventually be a pot of gold at the end of the rainbow. The key to success in the stock market is not about picking the all-time winners, it is in avoiding disasters. That is why learning from other people’s mistakes, rather than your own, is so important. Be wary of deeply cyclical industries and companies whose fortunes are in steep decline, or suffer from erratic cash flow, a high and rising debt load, union and legacy liabilities, reliance on just a few large customers, and led by a serial acquirer. All reasons why the selling-short techniques of the hedge funds have caught the fancy of many traditional, mainstream investors. According to the Risk Management Association, the

worldwide value of borrowed stocks rose fivefold from 1988 to 2006, to reach US$500 billion. The rationale is quite simple: the strategy allows the perpetrators to profit from the demise of expensive stocks while, at the same time, making money the old-fashioned way in buying out-of-favour ones with the potential to lead the relative performance parade. Though the same process of evaluation applies to both, there are problems with the concept as, despite the actions of the savviest practitioners, equity prices rise as economies grow, and inevitably they will. If you own a stock outright the potential appreciation is infinite, and there is no possibility of losing more than 100 percent of your investment. In the opposite case the probabilities are reversed. In addition, the security lenders require a measure of interest be paid in advance of delivery, the greater the number of shares and requests the higher the charge. There are murky problems as well, given as the culprits have an incentive to bad-mouth the company and question its prospects, which can lead to an acrimonious relationship with the management and long-standing investors.

As to the new-rage 130/30 "alpha" funds, not only must they make the right picks, if the overall market continues along its merry way, they stand to lose a bucket of money as time goes one. Until there is a protracted bear market, as there was from early 2000 to late 2002, it is highly improbable the now 8,000-plus hedge funds as a whole will better the returns realized by the more traditional money managers. They do not trade in and out at such a furious pace, nor cause as much volatility in the bond, stock or commodity markets, nor charge a management fee of 2 percent, nor take 20 percent of the profits above a predetermined benchmark from one year to the next. The very idea that a fee-upon-fee-grabbing fund of hedge funds would be an appropriate way for small investors to beat the odds is an almost sure sign the game is about over, many of the highly paid proponents now doing their level best to get into the even more lucrative private-equity business.

NOT SO PRIVATE EQUITY

Every few years there is a shift in the type of financier that becomes the rock-star embodiment of unfettered capitalism. The 1980s' icon was the investment banker. The 1990s belonged to the venture capitalist. The first years of the new millennium were that of the hedge fund manager. The player who gets most of the attention these days is the private equiteer. Some suggest Sarbanes-Oxley and the like have been a silent partner, driving companies away from the regulatory web that comes with public ownership. Once the scourge of CEOs, they are now wooed by potential targets and hailed as corporate alchemists who, having taken over a company, are expected to work their magic on its operations, and subsequently exit to massive profits in an IPO.

The hedge and private equity funds, with a combined total of more than US$1.3 trillion at their disposal, have the potential to turn the business world upside down. The first adept at putting undervalued entities in play, only to have the second swoop in to buy them up. With about a thousand of the latter looking for action, not even those with a multiple-voting share structure are safe, as poison pills are generally employed to buy time, not kill deals. Huge takeover premiums have increased public investor wealth, and more such undertakings are sure to come, with the result that returns are being squeezed, and it is becoming ever more difficult to realize extraordinary gains. The best defense remains a solid offense. Those issuers who have gained creditable research analyst support are likely to weather the storm. Thanks to a bid price that reflects premium-to-peer-group multiples of cash flow and earnings, they would be of little interest to the cavalier fund managers.

Dramatic growth in the Canadian market led to record levels of private equity investment in 2006, doubling from US$4.5 to US$10.9 billion. Approximately US$3 billion – or 27 percent – was accounted for by domestic investors. Globally, the industry is forecast to raise up to US$500 billion this year, topping the US$432-billion take of a year ago. The sponsors say they are convinced opportunities abound for buyouts, real estate, mezzanine, infrastructure, distressed debt, and other investing exotica. However, it would be a complete historical aberration for there not to be reasonably significant default rates in time. The traditional yardsticks such as price-to-EBITDA are already up to 20 percent, and price inflation is acute in middle-market transactions. The giant-size firms have such a store of cash that even when one or two get singed, and the inevitable credit pullback occurs, they may still have the wherewithal to carry on. But, I have my doubts as to the many others pressed to do a deal just to prove their mettle. It is they who can be expected to meet their maker headed in the opposite direction. This leads me to believe that the premiums paid on takeovers will mellow, and investors would be wise to read the prospectus before buying part of a coming-public-again IPO.

Though many are skeptical of the private equity asset-stripping business model, and a growing number of union leaders are up in arms about the potential loss of many thousands of jobs if domestic production is subsequently moved offshore, nothing is more maddening than the vast sums paid to the perpetrators. Now comes word the more prominent gunslingers have suggested that a government or regulatory clampdown would fundamentally damage the broader economy, a bluff worth calling before things get completely out of hand. After all, few of us have forgotten about the short life of Long Term Capital Management or the spectacular blowup of Amaranth Investors. Mark my word, if the authorities fail to get a handle on the private-equity players now, all hell will eventually break loose, costing investors untold billions of dollars.

At the moment few of the daredevils seem to be properly prepared to cope with the harsh political fallout in the event of a serious stock market correction. If some of the companies they have burdened with inappropriate levels of debt fail, the controversy surrounding the preferential treatment enjoyed by private equity executives – whereby the profits are often deemed to be capital gains – will be acute. By comparison, the outcry as a result of the changes to the rules governing Canadian royalty and income trusts will seem like a firecracker in the midst of a violent thunderstorm. As has often been said, it is far easier to stay out of trouble than to get out of it, and many of these managers will soon be in the penalty box. However, before such comes to pass, please be advised that in 2006, Goldman Sachs Group Inc., the pre-eminent firm in the hedge and private equity fund business, saw earnings increase by 70 percent to US$9.4 billion on revenues of US$37.67 billion. It set aside a total of US$16.5 billion for salaries, bonuses, and benefits, an average of US$622,000 per employee. It is not surprising the top graduates from the most prestigious universities about the globe are hoping to get hired by Wall Street firms. If I was younger, I probably would too!

Corporately speaking, rare is the executive willing to admit to being overpaid. Most CEOs believe they are worth more than their weight in gold – even at US$1,000 an ounce! Many seem to think they deserve at least as much in total compensation as another running an outfit of comparable size, conveniently forgetting about the relative performance of the respective stock prices. This helps to explain why their overall take has ballooned from something like thirty times the lowest-rung employee's, to nearly 400 times in the US, 240

in Canada. Unfortunately for investors, seldom do these prima donnas ever amount to much in terms of creating value. Owning very few shares outright, why should they care except when their options are in the money. If, on the other hand, one is a significant shareholder, the chances of intentionally undercutting the investors are much reduced, understanding that a rising multiple of steadily increasing earnings will create greater wealth longer term than any salary and benefits might. A word to the greedy: it takes an inordinate amount of patience to gain an enviable reputation, but it can be destroyed in no time at all.

A board of directors' primary responsibility is to see that an enterprise is run in the best interest of all the shareholders. The members must be made to understand that the CEO only deserves to be paid what is reasonable, and getting rid of an incompetent will have a positive impact on security prices by raising investor expectations that an incoming top-runger can only make matters better for everyone, not worse.

LOOKING TO THE FUTURE

When it comes to investing, do not allow the myths proffered by the pundits fool you into thinking making a fortune in the capital markets is simple and straight forward. It is not! Whereas the stock charts can point to past performance, the future may not hold true. They are not a magic wand telling you to buy flying-saucer bottoms or sell head-and-shoulder tops. Be suspicious of those who try to forecast the economy as a way to foretell what security prices are likely to do, as quite the opposite may come to pass. Rather, valuations and the trend in interest rates are the key factors. The time to commit to the cyclicals is when the particular industry is losing money hand over fist, and the commentators say things can only get worse. One is wise to sell once the critics capitulate, when you know intuitively there is little in the way of additional upside potential. Though pullbacks are inevitable, it is always better to stay a step or two ahead of the masses, than to follow. Let proper due diligence be your guide, not the traditional benchmarks like the S&P/TSX composite or the S&P 500, as they are rarely a true representation of what is actually going on. It is often a good time to start thinking about bailing out whenever the powers that be add a new name to the list, and the index-linked funds are through adjusting portfolios accordingly. The reverse is true when a stock is dropped and nobody important wants to own it.

If you are the CEO of such an underdog, never stop barking. As long as you are committed to a comprehensive investor relations programme aiming to keep the investment community in the know and listen to what the research analysts have to say, there is a better than even chance times will take a turn for the better. If you refuse or fail to do so, there will be nobody but yourself to blame if the hedge funds come a-calling and you are sent packing when a private equity buccaneer takes over. Getting another well-paying job may be almost impossible to tie down, your name having been dragged through the mud by your competitors and those who threw you out of the corner office. It is better to be forewarned, than sorry. Thank you for bearing with me!