

# LEITH WHEELER INVESTMENT OUTLOOK



Second Quarter 2006

## The Rediscovery of Canada

After years of neglect, investors have rediscovered Canadian Equities. Since the stock market bottom in September 2002, the TSX Composite Index has posted three years of very high returns

2003	27%
2004	14%
2005	24%

Pretty heady stuff as Canada has been one of the more attractive equity markets in the world over this time frame. The reasons for this stellar performance are many, but overall Canada has benefited because we possess many of the commodities – oil, copper, zinc, potash, aluminum etc – that are needed to assist the developing world (China and India) in achieving their growth goals. This hunger has resulted in significant commodity price appreciation particularly in the energy sector. While natural gas prices recently slid due to a warmer than average winter, both oil and uranium prices have soared. Our domestic energy companies and their related service sectors have all posted impressive share price appreciation.

Unlike previous commodity bull cycles, this one has so far enjoyed a fairly benign inflationary backdrop. In previous cycles, rising commodity prices were accompanied by wage increases and higher prices for goods. This inflationary pressure usually causes monetary authorities to intervene by aggressively raising short-term interest rates. In most cases this action is accompanied by long term interest rates also moving higher. Interestingly this economic cycle so far has been different. In the aftermath of the technology bubble, Central Banks slashed interest rates to revive an ailing North American economy. While a lot of this stimulative interest rate policy has been reversed, the pace of the tightening has yet to cause a prolonged inversion of the yield curve. Instead the yield curve, or the cost of borrowing, has remained favorable for the profits of our financial services sector. This situation has translated into higher profits and higher share prices for the Canadian financial sector.

What is especially eye catching and worthy of review is how the Canadian Equity market has changed over the last five years. In March 2006 the TSX achieved a record high of 12,111. Back in August 2000, the TSX achieved a tech mania high of 11,248 followed by a gut wrenching two year bear market that took the index all the way down to 5,695. The market euphoria in 1999 and 2000 was unique as investors for the most part focused entirely on technology stocks and cared little for other industries. This can be more clearly seen by examining the following table.

TSX Sector Weight (%)

	August 2000	March 2006	% Change
Energy	7.6	29.8	292
Materials	7.3	15.4	111
Industrials	8.1	5.6	(31)
Consumer Discretionary	8.1	5.1	(37)
Consumer Staples	1.4	2.8	100
Health Care	2.3	1.2	(48)
Financials	16.5	30.3	84
Info Tech	42.5	4.0	(91)
Telecommunications	4.2	4.5	7
Utilities	2.2	1.4	(36)

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What is clearly evident is that a sea change of immense proportions has occurred affecting the make-up of Canada's major stock index. Or to put it another way, yesterday's winner(s) (i.e. Information Technology) have become today's losers and the neglected groups of 2000 (i.e. The Old Economy) have become today's favored stocks, and are now a large part of the index.

Our stock selection process at Leith Wheeler is a "bottom up" approach. By that we mean we downplay macro-factors such as interest rates, GDP growth rates and other big picture factors in our stock picking process. Instead we look at individual equities and their valuations, always on the hunt for the "cheap" and "unloved." In most cases our research turns up "cheap" in two different categories. The first category is what we refer to as the black cloud phenomenon. By this we mean a company that has stumbled and is temporarily out of favor. In most cases, the company has failed to properly implement its business plan and has incurred financial losses or has failed to live up to expectations. However based on our work all is not lost and problem(s) can be resolved, usually over time. Past examples of this type of investment include the Canadian Imperial Bank of Commerce, Creo Inc. and Terasen Inc. The other category is a stock that seems to be poorly understood. Many times investors have confused ideas about what the critical profit drivers of a particular business are and focus on the wrong issues. Stocks such as Saputo Inc., Nexen Inc. or Enerflex Systems, fit this category.

By following a "value" strategy and looking for "cheap" and "unloved" securities, our portfolio seldom looks similar to the make-up of the TSX Composite Index. For example during the technology bubble we didn't own what our research determined to be overvalued technology stocks. Back then they weren't "cheap" or "unloved." Similarly today, our stock selection process has led us away from two very cyclical groups: Energy and Materials which together now comprise nearly one half of the weight in the TSX Composite Index.

Obviously, we recognize that the attributes and valuations of oil, gas and mining stocks today are tremendously different from the nosebleed valuations afforded to technology stocks in 1999 and 2000. But things change and as investors discovered to their dismay in 2001 and 2002, technology spending is cyclical. When it declines, company profitability drops and share prices...well you know the rest. Are things different this time with the demand for commodities? Could demand slacken? Is it possible that high commodity prices could retreat? Maybe the answer is "perhaps" to all three questions. From our perspective we are sure of two things regarding today's favored cyclical stocks - they are not "cheap" and they are certainly not "unloved."

Successful investing requires looking forward in such a way as to not simply extrapolate from the past. The last three years have been wonderful for Canadian Equity investors. Although current investment sentiment is not euphoric (like 2000), it is comfortable and complacent. As Warren Buffett, the sage of Omaha said, "its optimism that is the enemy of the rational buyer. The most common cause of low prices is pessimism. We want to do business in such an environment, not because we like pessimism, but because we like the prices it produces." While this attitude may strike some as unusual, most long-term investors will realize the wisdom behind this thought process. As for our forecasting ability, we realize that many are far more gifted. We will however maintain our search for the "cheap" and "unloved".

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