REVIEW & COMMENTARY
3RD QUARTER 2006

Requiem for the Resource-less

For decades Canadians have profitably packaged, refined and transported natural resources to consumers across the globe. Many of us profited nicely as the underlying stock prices of the companies involved in this trade grew over past decades but it wasn't until recently that the finality of this potential trend hit home. Within the past quarter, two venerable names, Falconbridge and Inco, have been taken from us. These companies, which have grown to represent Canada, and represent the inherent riches within it, have been sold to the highest bidder. Are there any companies in the foreground that may eventually rise to replace them? It would appear not. What is going to happen when the real wealth generators of the past decade, namely China and those in the Mid to Far East, find they can't spend money fast enough? They will probably do much more of the same, buy those things they need the most- resources, moreover, the companies that own them. As this happens, the complexion of the Canadian capital markets might look quite ashen as compared to the past few years.

Most regrettably, these very companies may now look back on what they might have done differently not only to ensure their own viability, but also to avoid being swept up by companies with a global, rather than a hemispheric, perspective. Should Inco and Falconbridge have consolidated themselves and then build outward through acquisition? Easier said than done, given their long history as competitors but as Nationalists, we would have been happier if they had. Look at Alcan, Thomson Corp, and Manulife, to name a few, that have looked beyond North American borders and, while not immune to a takeover, are more likely to consume rather than be consumed. The world is shrinking; pity those great Canadian companies who don't realize it.

While on the topic of shrinking, Amaranth, a U.S. hedge fund, will soon be dissolved. Reportedly boasting profits from natural gas trading of more than 2 billion dollars in August year to date, by mid September the trader responsible had lost close to $6 billion- quite a dramatic swing- $8 billion dollars- in only a few weeks. CNBC stated in early October that over 1,000 hedge funds had closed on Wall Street in the past two years. What separates hedge funds from more traditional managers such as SIM Ltd is that they get paid more if they outperform the index (market) through what is known as performance fees. Performance fees heavily favour the manager not the client. Much like corporate options, they provide a risk free call on the upside but expose the manager to little of the downside risk. Given that the majority of managers do not out-perform the markets every year, shouldn't they allow their clients to retain all of the upside returns when they have to absorb all of the downside? To beat the market, a manager may either use leverage (borrow additional funds), take more risk than the market- i.e. concentrate your portfolio in fewer areas (do not properly diversify) or take riskier bets. Amaranth, from what has been made public, did all of the above. Not everyone can run fast, or wants to, but those with patience can always finish the race.

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While it is never recommended to tempt the financial markets when you are right, it is equally misplaced to forget what you have said- unless, apparently, one is faced with a Congressional Investigation. Nonetheless, here are two quotes from our first quarterly Review and Commentary- written in early January 2006;

> *"Interest rates will rise marginally in the first half of the year then moderate thereafter…we would not presently overweight portfolios in energy- something we didn't do in 2005 either".*

Admittedly, we had also predicted that oil prices would not hit new highs in 2006 (which was wrong on two occasions, we had not properly considered geo-political tensions surrounding, among other things, the enrichment of uranium). But now the precipitous fall of crude oil prices suggest to us that there may be forces beyond this decline more than merely supply and demand. Some of the drop must be those remaining hedge funds who are unwinding positions- remember they tend to have a shorter term focus than most others and they tend to concentrate their investments.

Lower oil prices and lower interest rates will help North American economies avoid slipping into a recession. U.S. equity markets, which are less resource based than Canada's are performing relatively well and, if we don't have a repeat of the Long Term Capital debacle (the first big hedge fund bust that required U.S. regulatory intervention), this performance should continue. Remember, approximately two thirds of all goods in North America are transported by land so any relief in transportation costs is going to have a significant impact on the cost of goods sold (good for corporations) and, in turn, consumers (you).

And consumers will need some help. Daniel Gross, in the October 1st edition of the Sunday New York Times wrote an article titled *Even if Rates Don't Move, the Interest Bill Will Rise.* He claims that over $2 Trillion dollars of Adjustable Rate Mortgages are scheduled to be reset at higher rates which could cost consumers of such mortgages approximately $50 *billion* dollars more. Given the cost of carry will increase, it will be nice that it won't cost as much to drive your car to the bank to make your mortgage payments.

Despite the potential of a mortgage refinancing drain, a meltdown in a few of the hedge funds, there are abundant levels of cash on the sidelines. Private equity funds have raised cash with equal alacrity as hedge funds and are faced with the equal pressures to perform. With all this money looking for a 'home run', we may find more and more publicly traded companies as targets. Many of these corporations have very high levels of cash too. Morgan Stanley recently released a list of several LBO/MBO targets trading between $50 and $100 billion. Yes, between $50 and $100 *billion*. As well, the ongoing restrictions of Sarbanes-Oxley make many a CEO seriously consider going private a viable option- the only problem would be whether they would be able to stomach the drastic pay cut they may have to take.

In conclusion, though the non-systemic risk to the market continues, we do not feel that the fundamentals point to anything more than a slowing of the economy and remain positive that the recent market volatility is little more than a constructive reinforcement of our conservative approach to investment management. However, if the 'resource-less' trend we discussed earlier gains momentum, we may look back at this quarter with some remorse.

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