NEWSLETTER #1
AUGUST 14, 2006

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PERENNIAL PERSPECTIVE

STEP BACK – NOW WHAT DO YOU SEE

As I have been following the difficulties in the Middle East, I am frustrated by the newspaper coverage. It is not what you are probably thinking; I have come to the realization that the valuable parts of a newspaper are the advertisements and the editorials. The news in the paper is not current enough and I am forced to go to the internet where I can find out what is going on now.
Access to up to the minute news for the news junkie has never been better. However to understand these events, one must view them in an historical context. Looking at the current events in Lebanon without understanding what happened in the months and years before this crisis provides a myopic view of what is taking place.

Despite the easy access to information, getting an unbiased account of history from any one of the many papers or from one of the television news shows is also almost impossible. Each organization comes to the issue with a point of view that is evident from their presentation. While this is very clear as I look for insight in today's current events, the coverage in the world of investing is no different.

INVESTING TODAY

In the investment business, oil and gas has been the topic of discussion for the past three years. We read how China and India are increasing their demand for oil at an astounding rate and it appears to be an accepted fact that the world is running out of supply. Respected companies such as Goldman Sachs and investment experts like T. Boone Pickens and Jim Rogers are predicting oil will soon reach $100 and stay there. The media love these stories because they generate fear for you and me and investment firms love them because they whip up investment frenzy. For both these groups, stories of fear generate increased revenue.

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THE HISTORICAL LESSON — OIL PREDICITIONS

When reviewing previous predictions about oil, one becomes less concerned about the current situation. The world has witnessed these types of markets and forecasts before and the price of oil has always returned to a sustainable level.

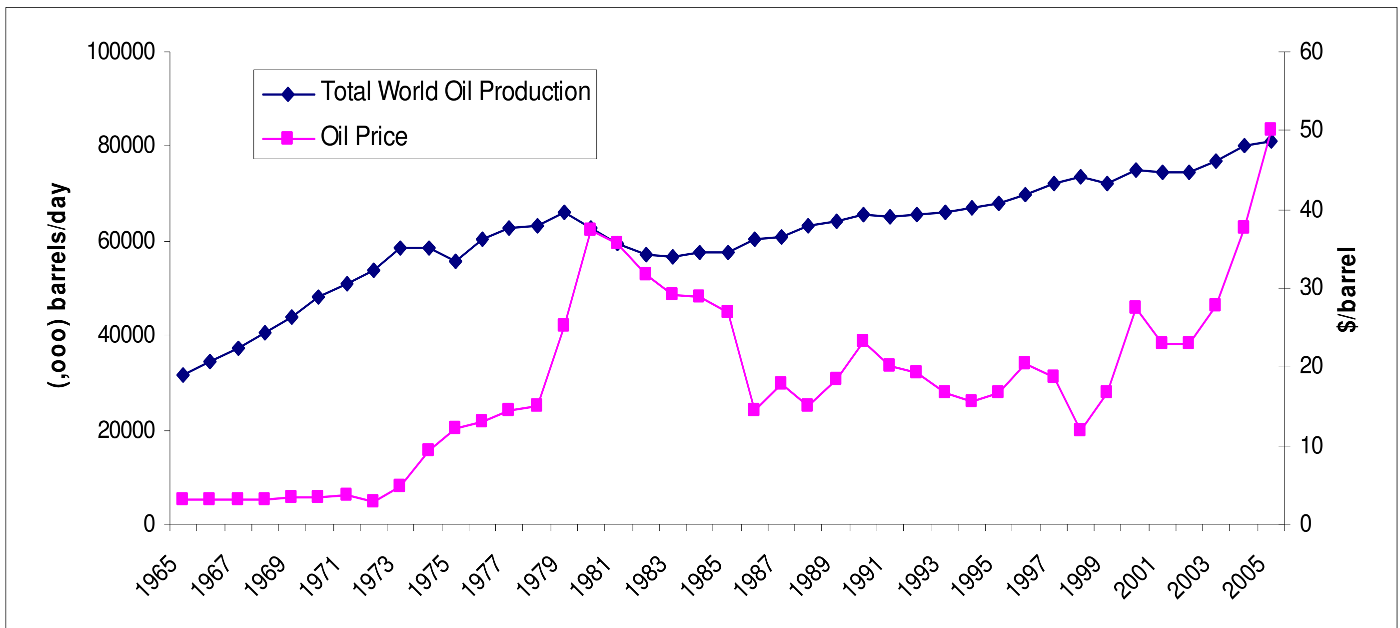
In 1874, the state geologist of Pennsylvania, the nation's leading oil-producing state, estimated that only enough U.S. oil remained to keep the nation's kerosene lamps burning for four years.

In 1973, State Department Analyst James Atkins, then the chief U.S. policymaker on oil, wrote an article in Foreign Affairs magazine titled "The Oil Crisis: This time the wolf is here" that also predicted a crisis due to lack of oil supplies.

In 1979, President Jimmy Carter, echoing a CIA assessment, said that oil wells "were drying up all over the world".

At the end of 1970, non-OPEC countries had about 200 billion barrels of proved reserves. In the next 33 years, those counties produced 460 billion barrels of oil and they still had 209 billion barrels of reserves remaining. Inventory was being used up at a rate of 7% per year and they were still able to replace it through exploration. The OPEC countries started with 412 billion barrels in 1970 and by 2003 they had produced 307 billion barrels and had built their proved reserves to 819 billion barrels.

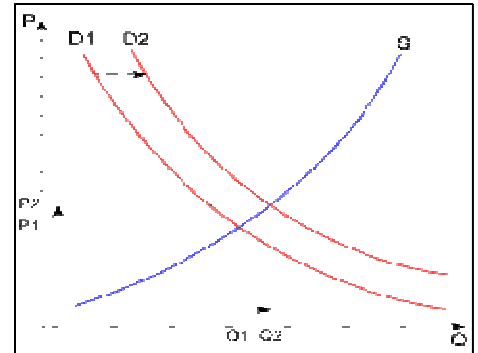
The production of oil and the price of oil both fell after the 1980 peak oil price.



BASIC ECONOMICS

What happened that made the previous predictions of impending shortages so wrong? All of these predictions of impending doom failed to come true because the free market works. In 1st year university economics class I learned about the basic supply-demand curve depicted here.

This graph illustrates the changes in supply, demand and price due to market forces. In theory, if demand for oil increases faster than supply, then the price for oil will increase. Oil prices have soared from an average price of under $23/barrel for all of 2002 to over $74/barrel today. The same economics class taught me that when prices move higher, the consumer's behavior (demand) is expected to change. In the short-term consumers cannot change their behavior dramatically but over time they will make the necessary adjustments.



CONSUMER BEHAVIOR

The Impact of Higher Oil Prices

When prices get too high consumers figure out how to use less oil.

1. *They use smaller more fuel-efficient cars.*
2. *They buy more fuel-efficient furnaces and appliances.*
3. *They keep their house colder in winter and warmer in summer.*
4. *People will carpool, use mass transit and reduce pleasure travel.*
5. *Manufacturers revise their processes and change their inputs to reduce oil consumption.*

New oil supplies are unearthed because the high price encourages greater funds for exploration.

1. *Offshore oil was uneconomic until after 1970. Now it represents around 30% of production.*
2. *More than a hundred billion dollars is being spent developing the oil sands in the next 10 years.*
3. *Shale oil is being evaluated as another potential source of supply.*
4. *New technology is being applied to bring additional production from previously abandoned wells.*

Alternate products replace the need for oil.

1. *Improved wind technology, solar technology and biomass are being applied worldwide.*
2. *Clean coal technology improves the environmental impact and coal usage increases.*
3. *Nuclear power generation undergoes a revival.*

THE IMPACT ON STOCK PRICES

Over the last three years, the price of most oil company's shares rose dramatically. As can be seen from the graph below, the Amex oil index rose by 160% while the S&P500 index was up only 30%. Obviously, oil has been the place to be.

Today with share prices so high, the risk/return ratio is much different than it was when oil averaged $22/barrel and share prices were less than ½ what they are today. The risk is much higher today than it was 3 years ago and the return potential is much lower.

- Oil is a commodity and commodity prices rise and fall on a regular basis.
- Drilling has increased dramatically. In theory, the more you drill the greater the likelihood you will find oil. According to Baker Hughes the number of drilling rigs in the world has increased to 2,993 as at December 2005 from 1,957 in December 2002. This is a 53% increase. If the theory is correct, supply should be increasing.
- Consumer behavior is changing.

INVESTMENT SUGGESTION

What's Next?

If oil shares do not represent the same opportunity today, where should we be investing? We believe you should be looking for investments that look like oil and gas did in 1998. At that time oil and gas prices were low. Very little was being spent on exploration and nobody was interested in oil stocks. That does not mean they were the best investment that year; you would have made a lot more money in Nortel or JDS Uniphase for the next 2 years. However, it was a sound investment choice that would have produced a generous return over the following 8 years.

The market as a whole is not inexpensive today but there is still excellent value to be found in some areas. The large international pharmaceutical companies for example represent great value and consequently we have been buying them since January. This industry peaked 5 years ago and it has been under pressure for two reasons; first many of the older blockbuster drugs are coming off patent and their revenue streams will be reduced because they will face pressure from the generic drugs and second there was a concern that the legal fallout associated with Vioxx would extend throughout the industry. We believe these issues have been discounted in the market and we find the companies now trading at values not seen for over a decade. The following graph details the performance of the Drug Group over the past eight years. During this time, the drug stocks have fallen over 20% while the S&P500 has risen 1%. Both have greatly under-performed the Amex oil index's 160% gain over the same time period.

VALUE COMPARISON

Valuation Metric	07/21/06	12/31/98	Discount
P/E Multiple	18.7	37	49.5%
Dividend Yield	2.5%	1.2%	52%
Price/Book Value	4.5	13	63%
Price/Cash Flow	14.7	33.6	56%
Price/Sales	3.6	6.5	45%
Average			53%

Today, these companies on average are trading at prices that are 50% less than they would be trading at if you used multiples from 1998. There are many great companies within this group and some are trading at valuations that are substantially less than the averages shown here.

Are we going to need new pharmaceuticals in the years to come? Will the number of people needing these products increase? Are we going to be willing to pay for them? I think the answers to these questions are self-evident. The companies in this group are among the most respected and stable in the United States. If they can be purchased at the right price, the only thing you should need to make a great return is time.

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To earn a good investment return, you do not need to follow the crowd; you do not need to be a nimble trader and you do not have to own the hottest new stock. All you need to do is be reasonable and buy stocks when they are trading at prices well below what they are worth.

THE MORE THINGS CHANGE, THE MORE THEY STAY THE SAME