

PERENNIAL PERSPECTIVE

UPDATE

In my last newsletter on August 14, 2006 I suggested there was both more opportunity and less risk in large pharmaceutical stocks than in oil and gas stocks. The price of oil proceeded to fall from \$74/barrel to under \$51/barrel and it currently sits at \$55, down 26%. During the same period, the pharmaceutical index rallied from 340 to 362 before falling back to about 360 where it trades now, up 6%. Taking a different direction than prevailing investment wisdom is often difficult but remaining reasonable and dispassionate again proved to be correct.

STEP BACK

On January 24th 2006, the Federal Conservative Party was elected to a minority government in Canada. Being a typical Canadian who has been disillusioned with the way our government has been run in the past, I believed all parties were the same and it did not really matter. However, it appears that there is something different going on.

The press has us keenly focused on numerous individual policy changes that the new government is working on and each of us will agree or disagree with them based on our personal viewpoint. If we can "step back" and look at all these policies as a group, we can see that there is a dramatic shift in attitude and policy underway. We believe this change will have a large impact on the long-term investment climate in Canada if the Conservatives remain in power. In this Newsletter we will look at the potential changes and impact on investments.

While we see the current government making many changes with less direct impact on business, for the purposes of this newsletter we are choosing to focus on the financial issues.

CONSERVATIVE PRINCIPLES

Late last year I happened to attend a gathering where Jason Kenney, who was Stephen Harper's Parliamentary Secretary, was speaking. He is now secretary of state for multiculturalism and Canadian identity. Mr. Kenney used the opportunity to highlight the government's "principle based" actions. He emphasized the government's demand at the Francophonie Summit that a change be made to a proposal regarding Lebanon and Israel to make it a balanced initiative and he also stressed the government's willingness to press the human rights issue with the Chinese. Both were examples of how the Conservatives acted based on principles, "it was obviously not in order to attract votes".

The current government also changed the taxation on "income trusts" which has not been a popular decision and was definitely not made to win votes. It appears to have been a decision based on tax fairness. As a principle, all companies should pay tax on the same basis despite having different legal structures.

This led me to consider the business policy priorities they are working on. The Conservatives are:

1. Considering opening the skies to foreign air carriers.
2. Reducing the involvement of the CRTC in telephone regulation.
3. Eliminating the Canada Wheat Board's monopoly.
4. Reducing red tape for business.
5. Reducing both personal and corporate taxes.
6. Reducing restrictions on foreign ownership of communications companies.

1. OPEN SKIES

Canada currently has only two open skies agreements, one with the United States and one with Britain. These agreements allow airlines from these countries to fly into Canada and Canadian airlines to fly into their countries as often as they wish with no controls on quality or size of aircraft. The U.S. for example has 77 such agreements with countries around the world. The Conservative Government is looking to expand the number of agreements and there is even talk they may consider opening up markets within Canada.

2. CRTC

The Conservative Government has recently reversed a CRTC decision regulating internet based phone providers (VOIP). The government's vision is that the business should be less regulated and that this will ultimately benefit the consumer.

3. THE CANADA WHEAT BOARD

The Canada Wheat Board is a marketing board that holds a monopoly on the sale of wheat and barley products from Manitoba, Saskatchewan and Alberta. It does not represent farmers from all parts of Canada or other farm products. The government is looking to extend to farmers the freedom to choose whether they want to keep selling their products through the board or whether they wish to sell their product privately.

4. REDUCING RED TAPE

In Finance Minister Jim Flaherty's fall economic statement, he committed the government to cutting unnecessary regulation and red tape. He made a commitment to reduce the Federal paper burden on business by 20%. This is not an original idea as similar initiatives have been undertaken in Ireland, England and Australia. The general notion is that unnecessary red tape hurts small business and it hampers the ability of entrepreneurs to succeed.

5. REDUCING TAXES

In Finance Minister Jim Flaherty's fall economic statement he committed to using budget surpluses to pay down debt. The ensuing reduction in interest expense on the lower debt would be applied to reducing personal taxes. He also committed Canada to having the lowest tax rate of all G7 countries on new business investment. As part of the Conservative election platform, the Conservatives suggested ways of reducing capital gains taxes. As of yet they have not made any changes with regards to this initiative but they have already reduced the taxes on Canadian dividends.

6. FOREIGN OWNERSHIP

The government is considering reducing foreign ownership restrictions in the communications arena. This would be an about-face from previous government policy and would fly in the face of those concerned about the demise of Canadian culture.

BALANCE

To be clear, this is not a political fundraising letter. I would like to bring up two issues which appear inconsistent with the other pro-business initiatives. The government is considering protectionist measures regarding the purchase of Canadian companies by foreign companies with government ties. This position has not been properly explained but it appears inappropriate given the Conservative Party's other views. The Conservatives also provided substantial financial aid to Pratt & Whitney Canada despite having previously expressed distaste for corporate handouts. Subsidies to specific businesses or industries are anathema to basic Conservative thought.

The overall policy thrust speaks to the Conservative's belief in free markets and competition. How will these changes play out in the investment markets?

IMPACT ON REGULATED COMPANIES

There are many examples of what happens when markets are deregulated. Jimmy Carter deregulated the U.S. transportation markets in the late 1970s and what occurred has been well documented. In the airline market:

- New low cost airlines emerged that offered no-frills service and employed non-union employees. The new airlines lowered fares.
- The incumbent airlines began lowering prices on competitive routes. They also abandoned many smaller markets that were not profitable and had been subsidized.
- Smaller airlines sprang up to service the abandoned markets often charging higher rates.
- Large carriers that were comfortable with the old regulated system struggled. Pan Am and Eastern Airlines for example were two large airlines that failed.
- The choices for consumers increased dramatically and prices fell. Service, quality and pricing became much more confusing.
- Consolidation of the new and smaller airlines occurred over time as scale proved important.
- The New York Times reported that after ten years, air fares had dropped by more than 25%.¹

Deregulation of long distance telephone service occurred in the United States and in Canada in the 1990s. The outcome was similar to that which occurred for airlines.

- New phone companies emerged that offered lower long distance rates. The New York Times reported that ten years after deregulation, U.S. long-distance rates had fallen more than 50%.¹
- The incumbent phone companies lowered their prices in competitive markets and raised prices for some rural markets.
- The choices for consumers increased dramatically and prices fell. However, service, quality and pricing became much more confusing.
- Consolidation to gain scale again reduced the number of participants over time.

WINNERS AND LOSERS

If the current government remains in power and if they continue to implement programs consistent with their described philosophy, the investment markets may be impacted as follows:

Positive

- ◆ The clearest winner will be the consumer as increased competition will bring lower prices and more choice.
- ◆ New and small businesses will benefit if they are positioned to compete with the established regulated players.
- ◆ Companies will have more time to spend on business generation and will be less consumed with “red tape”.
- ◆ Lower personal taxes will provide the consumer with more spending money.
- ◆ Lower corporate taxes will increase corporate profits and this will stimulate business spending.
- ◆ A higher standard of living normally follows.
- ◆ Capital goods companies should benefit from the spending of new competitors and from the extra cash companies have because taxes decrease.
- ◆ Consumer goods companies should benefit from a wealthier consumer.
- ◆ The reduction of ownership restrictions in regulated businesses will provide a broader group of interested buyers.
- ◆ It is difficult to pick specific companies that will be winners. Many of the winners do not exist yet and the majority of the benefits will be spread broadly across all businesses.
- ◆ Media and telecommunications companies may benefit from the reduction in foreign ownership restrictions.
- ◆ Banks may benefit in the future from an ability to merge and reduced foreign ownership restrictions.

Negative

- ◆ Established companies within the regulated industries which are being opened to more competition will feel pressure on revenue and margins. Cable, telephone, airlines, media, banks and utilities may feel this pressure and bankruptcies and reorganizations will increase.
- ◆ The consumer will find the numerous offerings more confusing.
- ◆ Companies that depend on government subsidies will not be able to count on this funding and growth will slow.
- ◆ Aerospace parts manufacturers may not be able to count on government assistance and growth should slow.
- ◆ Auto parts manufacturers may not count on subsidies to the big auto manufacturers and growth should slow.
- ◆ Banks and insurance companies may find their market more open to foreign competitors. Margins should suffer.

FINAL IMPACT

The Conservatives are following their principles and encouraging private enterprise to foster competition. If they remain in power it is only a matter of time before this principle is applied to other industries as well. It would seem prudent to invest with this in mind as it will reduce your portfolio's risk and improve your profit potential.

If the government is able to reduce bureaucracy, lower personal & corporate taxes and open up markets, economic theory suggests Canadians will benefit. Ireland is the best example of how significant the benefits can be. In Ireland, the GDP per capita doubled during the decade of the 90s. If similar results occur in Canada, then this strategy will be good for all Canadians. There will be more jobs, more wealth and a higher standard of living for both the fortunate and the less fortunate.

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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.