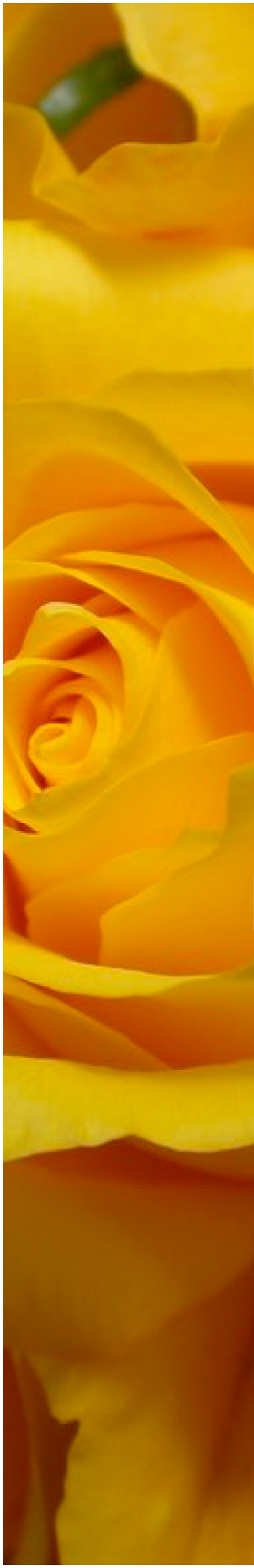

NEWSLETTER #3
MAY 22, 2007

PERENNIAL
ASSET MANAGEMENT

PERENNIAL PERSPECTIVE

UPDATE

I was very pleased that numerous people took the time to respond to our last newsletter. The responses were generally very supportive of the government's pro business strategy. One person expressed her concern about the funding cuts to the arts community but even she seemed resigned to the fact that the responsibility for funding our cultural institutions will fall more and more to private contributions. Thank you for the input.

PORTFOLIO UPDATE

We are currently very cautiously positioned in the stock market as we believe that investors with too much cash are buying investments without thinking of what will make them appreciate further. Whether it be real estate, art, stocks or bonds, investors today are buying because the prices are rising and everyone is making money. While we do not think that a crash is imminent, we do think it is time to alter your portfolio and be careful.

STEP BACK

In our first newsletter we used basic economics to evaluate the risk in oil prices, oil company profitability and oil and gas stocks. In our second, we looked at the open market policies of our current federal government. Today, we will look at whether people are using their intellects to invest or whether they are being conditioned to respond the way Pavlov trained his dogs.

Ivan Petrovich Pavlov won a Nobel prize for demonstrating that dogs could be trained to salivate to the sound of a ringing bell, not only at the sight of food1. In nature, the response to salivate at the sight of food evolved to help in an animal's survival. However, the learned response of salivating at the ringing of a bell outside the lab is not helpful to an animal's survival and would end up frustrating the dogs .

As investors, how can we ensure we respond appropriately and not like one of Pavlov's dogs

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THE LEARNED RESPONSE

What do we respond to and why do we respond in the way we do? The answer lies in the very concept of learning. When we looked up the meaning of "learning", we found the following definition:

"People are said to have learned when they have increased their options for applying to a specific set of circumstances, new or different behaviour which will be to their benefit."

We can deduce from this definition that in order to learn, people require the ability to:

- sense what is going on in their environment;
- assess whether their response to an event is beneficial or harmful;
- remember the event, their response and the consequences;
- respond next time with the appropriate behaviour based on their previous experience.

When we reflect on what Pavlov demonstrated with his dogs, we see that the problem lies not in the dogs' response, but rather in the type of stimulus they responded to. The bell is an artificial event completely unrelated to food, in technical terms an 'unassociated stimulus'. If we as people invest our money by responding to similar kinds of "unassociated stimuli", we will end up licking our investment wounds. The correct "learned" behaviour is based on "associated stimuli". In this case, that would be an improving economic environment and/or stronger corporate earnings potential in the future

So how can we ensure that we make decisions in the investment markets based on learning from associated stimuli?

RATIONAL INVESTING

When we look back over our experiences in the investment markets during the last 30 years, we can see a number of cycles with similar patterns. In the late 1970's, investors experienced a period of rising inflation which culminated with a boom in oil, gold and silver prices. In the late 1980's, investors flocked to real estate as they concluded you could not lose money investing in real estate. Finally, in the 1990's investors poured money into technology and telecom stocks because "we were entering a new business era". Each of the "boom" periods was followed by a "bust" that surprised investors and devastated portfolios.

As social animals, people feel comfortable doing things that we see others doing successfully. This leads to herd investing and it exacerbates the greed and fear mentality. Investing in a manner contrary to what "everyone knows" is the right thing to do is very difficult.

As we begin 2007, we question if something similar is occurring now with the stock market in its fifth year of expansion. What can we observe in these events that will help us avoid the investment missteps which damaged so many portfolios? How can we ensure that we are making investment decisions based on suitable stimuli? Let's review these historical examples and see what they reveal.

1970S: INFLATION...FROM FRIEND TO FOE

The period from the mid 1960s to 1980 was a time of irregularly rising and unusually high inflation. The rising inflation began to be more of a problem in 1972 when the US sold 440 million bushels of wheat to the Soviet Union, causing the price of wheat to almost triple. Shortly thereafter, the 1973 Arab/Israeli war broke out and the Arab members of OPEC refused to ship oil to nations that had supported Israel. The U.S. government in response instituted price controls on domestic oil production further exacerbating the supply problem. The price of oil quadrupled. The cumulative effects of these events together with an easy monetary policy, caused inflation to rise even while growth slowed. A new concept that surprised both central bankers and economists emerged. It was called "stagflation".

While these policies and events impacted inflation, we believe that the memory of the Great Depression and the desire to avoid another economic debacle was the real cause of the problem. Policy makers throughout the late 1960s and 1970s were willing to live with ever increasing inflation out of fear that stronger action to reduce inflation would drive the economy into another depression.

The end result was that by 1980, gold skyrocketed to over $800/ounce and silver hit $50. Oil rose from $3 to over $40/barrel with most analysts predicting its imminent rise to $50—$100/barrel. Energy stocks were doubling in price monthly and people lined up on King Street to buy gold & silver from the Bank of Nova Scotia. The Toronto stock market greatly out-performed the US markets because of the TSE's concentration in oil and mining.

Paul Volcker became the head of the US central bank in August 1979 and he raised interest rates dramatically to reduce money supply growth and curb inflation. As this new policy took hold, the markets changed direction dramatically.

<u>Important Observations</u>

1. Government intervention prevented the market from working effectively and kept demand artificially high.
2. The high oil price triggered increased production and reduced consumption; price changes impact supply and demand.
3. Inflation was harmful for most businesses but positive for real assets such as gold, oil, and real estate. While the US stock market weakened, Canada's resource market thrived.
4. Prices do not recover from a bubble quickly. Oil prices remained below the 1980 peak for over 20 years after the bubble burst and gold still has not reached its 1980 level.
5. Bond prices fell worldwide.

<u>What can we learn?</u>

Investors bought gold and oil stocks believing that there was something special that would keep them rising in price forever. Investors were trained, Pavlov like, that since they made money buying these stocks before, it was rational to assume they would continue to make money buying them in the future. This turned out rather badly.

1980s: THE REAL ESTATE SOLUTION

Long-term U.S. government bonds fell in response to Volcker's major policy change, driving yields to over 14% while treasury bill yields exceeded 19%. Thirty year mortgage rates in the US rose to as high as 18.5%. These rates put huge pressure on consumers and businesses. A recession began in 1981 and inflation, which peaked at 13.5% in 1981, fell to 3.2% by 1983

Oil and gold commodity prices plummeted and oil and gold stock values plunged. Gold began a 20 year slide and oil prices dropped to almost $10/barrel by the mid 80's as the consumer's inflationary psychology was broken. Many companies went bankrupt.

As Interest rates then began to fall, companies began to benefit from the lower interest rates and financial assets like stocks and bonds began to soar. Companies with real assets such as gold and oil remained depressed.

Real estate was the one real asset that recovered quickly from the decline in the early 80s. Investors' became even more comfortable with real estate and invested heavily in this sector.

In March 1987, interest rates began to rise. The stock market continued to perform relatively well until October when it crashed, falling 20% in one day. Real estate however, remained strong despite the stock market crash and investors fearful of another stock market crash invested heavily yet again in real estate .

Lenders competed aggressively with each other to finance real estate developers; often lending to projects with little or no equity. As property appreciated, lenders were willing to refinance and allow the equity investors to withdraw additional money from the property. They believed future rents would be much higher and the value of the property would increase. New building skyrocketed as real estate prices rose and financiers fought each other to fund ever riskier projects. The inevitable real estate market crash started in 1990.

Important Observations

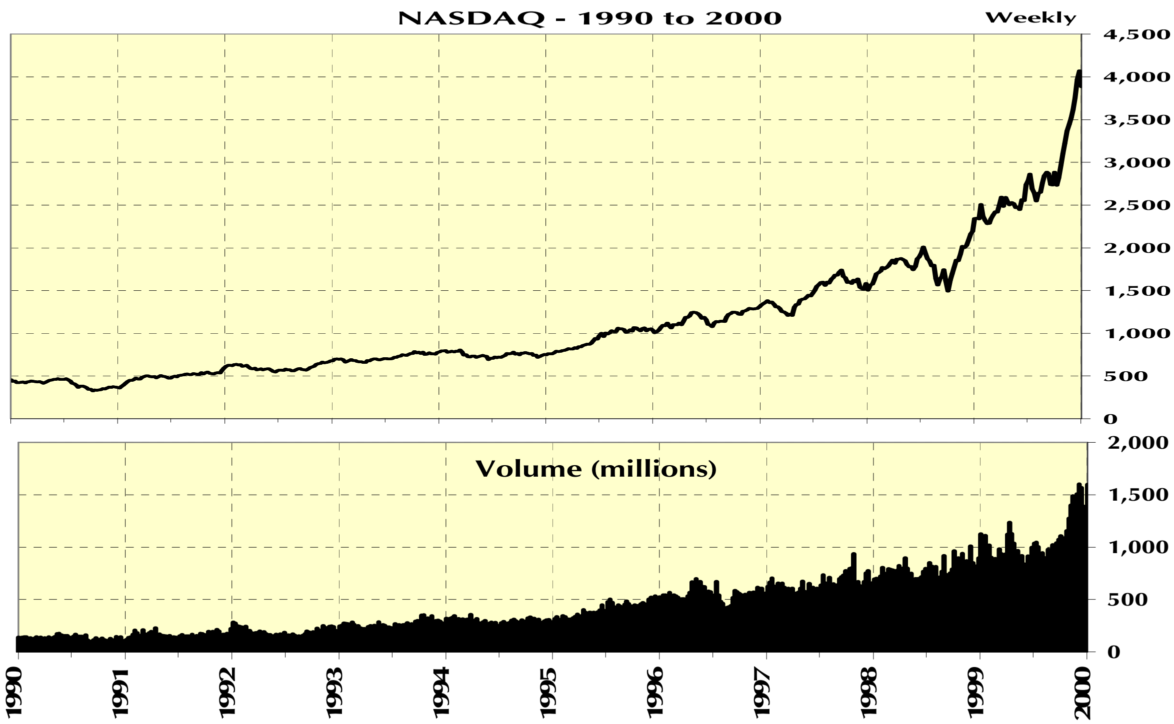
1. As with oil on the previous page, the large increase in real estate prices caused developers to dramatically add to supply . Customers at the same time learned how to economize and use less.
2. Assuming any investment has no risk can be very expensive. Risk increases as prices rise.
3. Market participants often lose sight of the big picture. Lenders looking at being a little more aggressive on a deal often miss that they made the decision to be a little more aggressive 20 times in the last year or two. Therefore, they took much more risk than was prudent.
4. Investing in a risky asset for a 4% cash return when long-term government bonds are yielding 11% is a bad deal.

What can we learn?

Investors kept buying real estate with the belief that there was something special about this asset and that it would keep rising in price forever. Investors were trained Pavlov like, that since they made money buying real estate before, it was rational to assume they would continue to make money buying more in the future. How wrong they were.

2000: TECHNOLOGIES NEW ERA

I do not think that we need to rehash this experience again as most investors remember it all too well.



Important Observations

1. The familiar example, Nortel had 524.5 million common shares outstanding at March 31, 1998 and the stock was $23/share (US). Two years later, it was trading at $90 and the company had 3.2 billion shares outstanding. What had happened to the company in two years to make it increase in value from $12 billion to $288 billion? It is easy to look back on it now and say that nothing made it worth that much, but it was just as evident then if we acted rationally and were not greedy.
2. Assuming the revenue growth that technology companies were experiencing would continue forever was no different than assuming oil would rise to $100/barrel in 1980 or that real estate only needed to provide a 4% return when bonds were yielding 11%. It is clear now that investors should have been more willing to consider following a different path.

What can we learn?

What occurred during this fervor was not unlike the previous experiences. People thought stock prices on their own actually meant something and they did not look behind the prices to understand what they were paying for the business. Investors became trained Pavlov like that since the technology stocks kept rising previously, it was rational to assume they would continue to rise. The results were bad yet again.

2007...NOW WHAT CAN WE SEE?

The North American stock markets bottomed in the fall of 2002 and have now been rising for more than 4 1/2 years. During that time:

- The TSX has risen 140%.
- The Dow Jones Industrials has risen more than 80%.
- The S&P 500 has risen over 90%
- The Nasdaq has risen 140%

However, the North American economies are also better than they were 4 1/2 years ago. Employment is robust. Personal income has risen briskly. Earnings for S&P500 companies are 75% higher at the end of 2006 than they were in 2002 and public company balance sheets are strong.

While public company balance sheets are strong, this does not mean there are low levels of debt in the system. Companies that have gone private through leveraged buyouts have high debt levels but these are not published. NYSE margin debt stands at the new all time high of $293 billion as at the end of March 2007, up from $130 billion in September 2002. This is a huge increase and an extremely high number when you consider that margin debt first hit $20 billion in October 1983 and it did not exceed $40 billion until September 1992. It took 11 years to increase 100%. In the last 15 years, it has increased by approximately 700%. High debt levels alone have not been a good predictor of the economy but in an economic downturn, debt is always an extra drag.

Along with Private Equity, hedge funds have been the investment of choice for some time. Hedge funds originally offered an innovative investment structure that promised high returns with relatively low risk. With the growth of hedge funds, most of the opportunities found by early practitioners have been fully exploited and neutralized. This has forced current managers to accept much more risk in order to earn high returns. Accepting risk in good markets can be rewarding. However, what will happen when markets turn? As Warren Buffet said “Only when the tide goes out do you discover who's been swimming naked”.

What can we expect?

1. Stocks are not cheap. As long as there are no shocks and interest rates remain low, markets should provide low returns.
2. Given that bond and stock markets have been good for a number of years they are currently pricing in low levels of risk. Markets will decline as risks are re-priced in.
3. The sub-prime mortgage market in the US was an area of excess and it is currently adjusting. This is healthy in the long run as aggressive lending leads to big problems.
4. Private equity is another area of intense competition. These investors are paying very high prices to acquire businesses. The bidding up and leveraging of these businesses is not without substantial risk to all market participants. There will be pain here.
5. Corporate mergers are also occurring at very high valuations as management are willing to pay for all potential synergistic benefits to position their company strategically. This will also end painfully for many.

How should we respond today?

As we said at the beginning, we do not believe we are at a point of major over-valuation as we were at the ends of the previous three decades. However, the present merger and acquisition frenzy is pushing prices very high across a very broad set of industries. This is cause for concern and we believe it is time to be conservative.

We have positioned our portfolios to protect capital until company valuations better compensate us for the risk we must assume by investing in them. Our longer-term investment perspective leads us to believe that there are always times when the markets get skittish. We will be in a position to take advantage of the opportunities when that time arrives.

Learning from Pavlov's findings can help us be better investors. We all know it is very hard to stay disciplined when markets are booming. When it comes to investing, we must not let our emotions take over when we should be using sound reasoning. Let the bell toll for someone else.

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