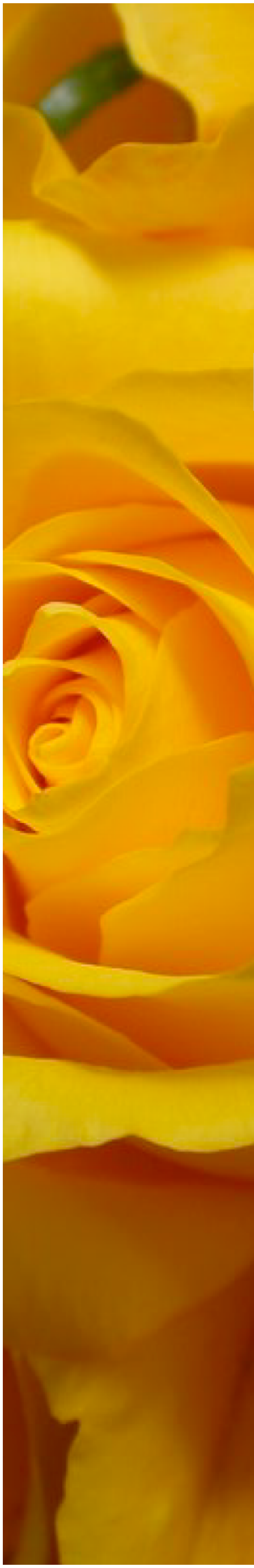

PERENNIAL
ASSET MANAGEMENT

**NEWSLETTER #4**
**SEPTEMBER 7, 2007**

# Perennial Perspective

## UPDATE

On May 22nd in our last newsletter this is what we wrote:

*"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."*

We then stated:

*"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."*


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# WHAT IS HAPPENING?

The sub-prime mortgage market appears to be even worse than we expected in May. People who should not have been given mortgages because of their inability to service the debt are now defaulting. Now that loan losses are skyrocketing, mortgage lenders are tightening their underwriting requirements; restricting the number of home buyers that qualify for a mortgage. Last month the unsold inventory of homes in the US was already the highest it has been in 16 years and many more sub-prime mortgages come up for re-pricing this fall.

Many lenders who issued the sub-prime mortgages repackaged them into asset backed securities and sold them to investors. Since the lenders were not planning on keeping the mortgages on their books, their underwriting standards were less stringent than if they had planned to own them. The more mortgage packages they sold, the more money they made and if the mortgages went into default, the problems would be somebody else's.

Many of these low quality mortgages were packaged with other similar securities into Mortgage Backed Securities (MBSs) and Collateralized Debt Obligations (CDOs). Significant proportions of these investments were then rated higher than the individual mortgages by the rating agencies. Investors bought these products relying on the ratings without worrying about what the underlying assets were. When the mortgages in these packages began to default, many investors who thought they were investing in very safe investments were shocked. Their response; buy the safest investments they can, government bonds and treasury bills.

The bottom line is that risk is starting to be priced back into the market as investors realize that it is possible to lose money. This re-pricing of risk is happening in almost all markets:

1. During August the conventional 10 Year mortgage spread* rose from 150 to 190 basis points. Sub-prime mortgages were no longer being offered at all.
2. As at September 6th the S&P 500 is up 4.2% for the year to date while it is down 5.8% from its peak. The S&P/TSX Index is up 6.9% year to date and down 5.4% from its peak. The Russell 2000 (a smaller capitalization index) is up 0.7% for the year to date and down 7.4% from its peak. The TSX Venture Index is down 7.3% for the year to date and is down 19.8% from its peak. Smaller and riskier indices and stocks of smaller companies are falling faster than the larger more established companies because they are riskier.
3. Treasury bill yields in the US fell from 4.7% to 3.9% during the month ending August 31, 2007 as people were putting more of their money in risk-fee investments.

While investors have been skittish as of late and have been hiding in the safest vehicles, the markets are still very close to their all time highs. Newspapers give the impression that the markets have been decimated but statistics show that is far from the truth.

* The difference between the yield on a 10 year mortgage and a 10 year government bond.

# WHY SO JUMPY?

Given that the market's performance has not been so bad why is it that everyone is so worried?

The European Central Bank, The Federal Reserve Board, the central banks of Canada, Australia, Russia and China all flooded the markets with hundreds of billions of dollars to provide liquidity to stop the credit market meltdown.

- The Federal Reserve Board cut the discount rate.
- Bill Gross the manager of the largest bond fund in the world called for central bank and federal government intervention.
- TV host and ex-hedge fund manager Jim Cramer temporarily lost control on TV as he ranted that the central bank had to intervene and save him and his hedge fund friends.
- Chairman of the Federal Reserve Board Ben Bernanke spoke to reassure markets.
- President George Bush even made a speech to try and calm the markets.

The answer to why everyone is so worried - ***leverage***.

We spoke about the amount of debt in the system in the last newsletter and while corporate balance sheets are very strong, hedge funds have been borrowing to squeeze big returns out of small spreads. When the markets turned against them, lenders forced many funds to be sellers into a market that had few buyers.

In addition to the hedge funds' position there was a record $2.7 trillion dollars in takeovers announced in the first six months of 2007 and on balance these are very highly levered transactions. When the credit markets started tightening up, the banks had outstanding commitments to provide financing for over $350 billion from their own balance sheets for these takeovers. Given the strong markets that we had previously enjoyed, the bankers believed they would be able to help the acquirers raise the money in the debt markets to eliminate the banks' responsibility.

The banks' ability to refinance these commitments looks difficult given the current state of the bond markets.

# WHAT NOW?

We currently are experiencing divergent trends; while we have been focusing on the financial markets current panic, workers are feeling strong. Unemployment is low and employee compensation is rising. The North American worker is finding herself in the strongest employment position she has been in for decades.

What does this mean for the markets and the economy?

1. Personal consumption should remain healthy as workers enjoy wage gains and strong employment conditions. Despite the worry that the consumer will have less cash from mortgage refinancing, we have observed that the increased income from greater employment has more than off-set this phenomenon and we would expect it to continue.
2. Corporate profits will not grow as most of the growth in GNP will be needed to cover higher costs including higher employee compensation.
3. Inflation will rise as employment costs increase worldwide. We will not be able to count on falling import prices from China and India to counteract higher domestic costs.
4. Financial companies will clean up lax loan underwriting and tighten lending standards which will reduce loan volumes. Financial companies will also find themselves in a position where they will need to increase reserves for loan losses. Together these issues will reduce earnings for lenders.
5. The bond market will gyrate as worries about inflation surface one week and dissipate the next when earnings growth disappoints or financial system concerns frighten investors. Inflation will ultimately dominate and interest rates will rise.
6. The stock market should trend lower over the short-term as current expectations for earnings growth will not be met.
7. Home prices in the US will stabilize at lower levels and prices will not recover for years as the current over-supply is eliminated. The recovery will occur slowly as banks will be more careful lenders.
8. Many highly leveraged hedge funds will collapse and investors will look for greater transparency, more reasonable fees and less leverage.
9. Developing countries' consumers will start to be a major factor in the growth of global consumer product markets.
10. After dealing with the losses which emanate from the current crisis, the large carefully managed financial institutions will thrive. Their smaller, aggressively managed competitors will struggle, if not fail, and the margins will widen for the strong survivors. The commercial banks will also find the demand for corporate loans stronger as the public markets will be less hospitable to higher risk corporate lending. This will be a more difficult environment for investment banks.

# FEAR AND OPPORTUNITY

All markets represent the balance of fear and opportunity.

Today's credit markets are dominated by fear and this will not subside until portfolios are repositioned.

Today's equity markets remain focused on opportunity as every correction is seen as a chance to profit from the next big rise in stock prices.

Our clients look to us to avoid frothy markets and we have been fortunate to have evaded this current market shake-out. We believe that markets usually go to extremes and we expect to take advantage of a further retrenchment to make good investments at excellent long-term values.

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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. Time will take care of the rest.*