

Autumn 2011

Interest rates are low. Companies are flush with cash, and not overreaching on expansion. The number of recessions that have started in similar environments? Zero.

Simply, companies are stronger today than in 2008, when the real estate bubble burst, taking the world financial institutions to the brink. Their balance sheets and earnings are ahead and their valuations are approaching the lows of 2009. Here's what others are disinclined to say: we are not on the brink of another recession. That realization will sink in, or be admitted to, soon. And when it does, markets will rebound. And, equally important, *fundamentals* are going to come back into fashion.

Given this declaration, and the complexity of what's occurred over the past few years, it seems to us a good time to remind our circle of tried-and-true principles, which may have been forgotten or ignored during recent turmoil, but never failed to be, well, true. When we speak of fundamentals, we're talking about the basics of company operations and the effects on investing. It first boils down to having a thorough understanding of these crucial things about a potential investment:

- The company's products and target market.
- Managements' ability to produce and deliver the products or services in a timely and economic manner.
- Costs involved in manufacturing or providing the goods and services.
- The forms of competition that currently exist and any new developments on the horizon that might alter consumers' views or appetite for the products or services.
- The company's ability to expand their facilities and/or employment.
- The capital available to carry out their businesses and the potential resources it can access to help pay for its continuing operations and possible expansion.
- The company's profits (or lack thereof) and ability to maintain or grow those profits over time.

Once these things are determined, investors then apply the *fundamentals of investing* to determine whether to invest their capital. Investors determine their expectations for return on their capital based on the company's operations and the prospects for future growth (*return expectation*); the likelihood of the company achieving those expectations (*risk assessment*); the alternatives available for investing (*allocation of capital decision*); the return for risking nothing (*risk-free rate*); and the expectations for inflation (*discount rate*). After making these determinations, investors decide what a company is worth and the risk they, the investors, are willing to accept.

Our firm belief is that these basics of long-term investing haven't changed. Investors look at the options for their money and decide where best to direct its placement. When we survey the investment landscape today, we see one-year US T-bill rates at 0.09% and Canadian one-year rates at 0.9%. Bank certificates of deposits are between 0.15% and 1% in the US and between 1.2% to 1.8% in Canada. Each of these are typically considered risk-free rates because investors feel the potential for loss is nearly non-existent.

With inflation running between 2.5% to 3%, investors in these assets are actually losing real purchasing power over time (meaning, their dollars buy less next year than they do today). When the net of taxes is included, this loss becomes even greater. Using these same low-risk instruments, and extending the investment commitment to ten years, allows an investor in US treasuries to lock

in an interest rate of 2.1%, or 2.2% using Canadian government bonds. This, too, is below the current inflation rates – especially after paying tax. Using the S&P 500 index and the S&P TSX index as proxies for large blue chip companies based in the US and Canada, we see a dividend yield of 2.25% to 2.95% with the ability for those cash payments to grow as company earnings increase over time (estimated at above 10% a year). It's these types of hard facts, not visceral, emotional reactions, that make us confident in our expectations. When investors begin to look past the turmoil and uncertainty (and they've already begun, but we're getting ahead of ourselves) and look at what lies beneath the fear, rational thought and decision making regarding risk and expected reward will again be the driving force in the markets.

To put this in perspective, let's look at a few companies that are fundamentally sound. The first is Target Corporation, which we own, a discount general retail store operator. Over the last three years, difficult economic times, as you know, Target Corporation has grown their sales from just under \$65 billion to \$67.4 billion and increased earnings from \$2.2 billion to just over \$2.9 billion. The company is expected to continue growing their earnings 11% annually over the next few years. Target pays a 2.3% dividend, having increased it annually for the last several years. It is currently trading at a price to earnings multiple of 12 times, a 23% discount from its average over the last six years.

Next, we offer Medco Health Solutions Inc., a pharmaceutical benefits manager, and another company we own, as an example. We see an even greater discrepancy from historic levels with Medco. The company has increased sales from \$44.5 billion to over \$65.9 billion over the last three years. Earnings have increased from \$912.0 million to over \$1.4 billion over that same time. The company does not pay a dividend but is expected to increase their earnings at a 13.3% annual clip over the next few years. Currently, the company trades for 11.9 times estimated earnings, a 48.8% discount from their average. These are just two examples of sound operators with great prospects for the future. Only investor fear has caused these companies to be discounted or, worse, ignored. That won't continue.

And others are seeing the light and actively improving their fundamentals. One such company is Teck Resources Ltd. In the middle of 2008, the company purchased Fording Canadian Coal Trust and, in doing so, took on \$8 billion of short-term debt. Back in 2009, many thought Teck wouldn't be able to pay down the debt in time. But the company sold non-strategic assets and used their cash from operations to reduce short-term debt from over \$7.7 billion to less than \$65 million, where it stands today. At the same time, they lowered their long-term debt by just over \$200 million. Sales have risen from \$6.6 billion to over \$9.3 billion, and earnings have gone from \$659 million to over \$1.8 billion. The company is trading at less than half its historic norm while steadily improving over the last few years.

Another example of a company making significant strides over the last few years has also received, often unfairly, a lot of bad press. If we look beyond the root-of-evil categorizations of the Wells Fargo & Company, we see a bank that has raised its tier 1 risk capital from around 6.5% to over 11.2%, significantly improving its ability to survive another shock to the bank and the banking system. The company has also increased its gross revenues from \$41 billion to over \$85 billion in the last three years. While the company has been forced to write off billions in bad loans, it has still been able to increase its provisions for future problems from \$5.3 billion in 2007 to over \$23 billion. This, again, increases its ability to weather the continuing mortgage problems. Through all this, the company has increased its earnings from \$8 billion in 2007 to \$12.3 billion in 2010. In spite of the obvious improvements the company has made, they are valued on a price to earnings basis at over a 35%

discount to historic levels.

We didn't have to go undercover to get this information and come to these conclusions. No cloak-and-dagger. This information is not widely discussed, but it's widely available. And it's only a matter of time, and not a considerable amount of it, before it'll be impossible to ignore and reality will match the market. When it does, a more rational investment climate will ensue. We're looking forward to the returns that are sure to follow.