

There is Some Light at the End of the Tunnel

These markets are volatile! As I write this letter, the Dow Jones Industrial average is down 9.9% month to date. Most European markets are down over 10%. The S&P/TSX Composite is down only 3% as it has benefitted from the strength in the price of gold and oil.

The reluctance of the US Federal Reserve to curb inflation by raising interest rates has assisted in weakening the US dollar. The waning confidence in the US currency has lead many market players to buy assets, such as gold and oil, as an alternative. As an example, this week a member of the Russian government suggested they will begin buying gold as a hedge against US inflation and a weakening dollar.

The pressure on the financial institutions has also increased. More asset write-downs have occurred and earnings estimates are continually being slashed. The credit crisis is not over. The market is still cleansing itself and until that concludes, weakness and concern will remain.

The light at the end of the tunnel is in the valuation in the market. As concerns in these markets increase, more opportunities are revealed. Outside of gold and energy companies, valuations have improved. This has given us an opportunity to add or introduce high quality companies at valuations we have not seen for some time. Two examples are found below.

Inside the Fund – Empire Company



Empire Company Limited reported its fourth quarter results this week. Empire is the owner of the grocer Sobeys as well as real estate investments. The bulk of its earnings come from the Sobeys grocery store. The results were very strong in a sector which is obviously exposed to wallet tightening consumers.

The grocery sector has recently seen margin compression as price competition has stepped up and costs such as energy have squeezed margins. The introduction of Wal-Mart Supercentres into the

Canadian market and its steady expansion has lead to irrational pricing. Wal-Mart stated they would be the lowest price in the market and a battle ensued. Sobeys has performed well. Empire initiated a cost cutting program, a re-bannering and store renovations to increase sales. In the last year, Sobeys opened, relocated, or acquired 66 stores. They also expanded 31 stores and closed 67. It is this type of portfolio re-jigging which helps to compete against aggressive competitors. Finally, the Sobeys strategy of high-low pricing has worked well. This is a strategy of bringing customers into the store with promotions (low prices) and selling them some of the regular priced items (relatively high). This is a very different strategy than low cost, providing an alternative for shoppers to Wal-mart.

Empire reported fourth quarter and annual numbers with increased operating margins while Loblaws and Metro reported a reduction in operating margins. Sobeys increased their sales over the last year by 5.6%.

Empire increased their dividend by 6%, the 13th consecutive annual increase, and reduced their debt level and committed to continue this trend.

The weakness in the stock over the last six months has provided a great opportunity to increase our position.

Genum Corporation

Genum also reported earnings this week. Genum designs semi-conductors to deliver High-Definition TV. It also produces chips to assist in data communication.

Genum is in the process of a turnaround. Franz Fink, a new CEO, was appointed in 2006. He began the transformation in 2007 by divesting the audio and wireless division, which made hearing aids and headsets. He also divested the manufacturing division. The result has been an increase in revenues, earnings and cash flow.

The exchange rate has been a headwind, however, management has offset this by focusing on improving the efficiency of the operation and increasing their product mix. A large uptick in research and development spending is expected to help launch new products.

We have owned a small weight in Genum for a number of years. However, in the past three months, the shares have been liquidated by investors at fire sale prices. We have waited nearly three years for the opportunity to double our position in the Fund and now Genum is a top ten weight in the portfolio. Our confidence has increased in witnessing the improvements made by the new leadership.