

## What's Next for Small Caps?

**"I'm phoning about my exposure to AIG, Lehman and Freddie Mac and Fanny Mae?"**

"You haven't any."

**"Whew."**

"You're invested in smaller Canadian companies. They have no exposure."

**"You own banks. The banks are in trouble."**

"No. Some banks are in trouble."

**"Are they going out of business?"**

"Only in America...and Germany."

**"Canadian banks?"**

"Read last Friday's David Dodge article in the Globe and Mail, former Governor of the Bank of Canada. Read between the lines."

**"What's between the lines?"**

"Apart from the Asset Backed fiasco, David pretty well dodged the bullet."

**"Oh!"**

"He kept our banks on a short lead. We should be grateful. This is a game of anticipation."

**"Okay, so what do we anticipate now for banks?"**

"Canadian banks will see lower profit growth, lower ROE's. Their growth rates were above trend for the last few years. They will record lower profit growth for the next few years. Share prices will slip. But a single digit zero is not in the cards."

**"What do you think about market volatility?"**

"What volatility?"

**"In the equity markets! The Dow and the TSX lost 500 points on Monday and then gained over 300 and 800 points on Friday."**

"Oh that."

**"It's scary. Is it the bottom?"**

"Don't take counsel from your fears. The actions this week will give the markets a little breathing room."

**"I'm glad to hear that."**

We don't think you should expect the guys who built the crisis to fix the crisis. The liquidity injection is a band-aid on a gaping wound. The breathing room is a little like the air in the Kursk, the Russian sub that sank in the Barents Sea a few years ago. The air is running out."

**"Is it a meltdown?"**

"Yup. It is a credit meltdown among super-levered American financial institutions lacking in regulatory oversight. We don't own them. As America's consumer is the big buyer of stuff around the globe, the meltdown will deflate the economic growth around the world, but...it is not the end of the world."

**"You seem pretty confident."**

"When you know the value of a business, how it is financed, and what it can earn, you're okay. It is the same with the market. The businesses will earn less in a recession, but if it's any good it will stay in business."

**"Shouldn't I be worried about my portfolio falling in price? What about the Canadian dollar, its falling. What about layoffs?"**

"Whoa. The price of your stocks may go down. We have tried only to buy enduring businesses able to pay their suppliers, their debts and their dividends. They can go down in price. They may retreat more than we may expect. They may cut their dividends. We have some pocket change to buy more if they tumble in price, in the worst case."

**"You seem to think things are going down."**

"We think that is a pretty good prognosis. Equities will trade to a level consistent with earning power of the underlying assets. The credit crunch will knock many points off the return on assets of the world's companies."

**“Well what is the asset value?”**

“It’s lower.”

**“Let’s get out.”**

“If we get out, we have to get out of everything. We don’t want to do that. Firstly, we don’t own businesses hopped up on debt. Thirty percent of the portfolio holds companies in a net cash position. Secondly, thirty-four of the forty-two companies pay dividends. Thirty-five increased their book value last year. The ones that did not were in the oil and gas businesses, where we have reduced our exposure. None has the built in risk of the American investment banks. Maybe some of the Canadian commodity producers are at risk from overvaluation, but we have been selling the expensive companies, the ones available in 2001 at a discount to book value. Finally, it is a market of stocks, we can find companies trading at low multiples of assets today, and we think we should buy them, just like the commodity companies in 2001.”

**“I’m scared anyway.”**

“Be scared *last year*, and the year before that, and the year before that. You should’ve been scared when making money is as easy as rollin’ outta bed. Be scared when they tell you we’re running out of oil in the world. Be scared when they say bubbles *can’t* be anticipated or when the analysts extrapolate 20 percent earnings growth rates in Canada, twice the historic rate, or when politicians tell you the economy is fundamentally sound. They are all blowin’ smoke.”

**“You didn’t answer my Canadian dollar question.”**

“It will fall with the commodity prices.”

**“You’re not worried about the crazy market moves.”**

“We like it. Beats watchin’ the Canadian election.”

**“You like it?”**

“The more shares fall the better value they are. We want others to be scared. Until Friday, that was working out pretty well.”

**“Alright, what’s next? Do all the actions help save the day?”**

“Let us say we save the day. The fact that the world’s central banks convened to place more liquidity in the system tells you things are not so good. Remember, the US economy, you know, the worlds “richest” economy, is levered three to one - \$51 trillion in debt to \$14 in the GDP, convincing us that the US Administration can save the day is like guaranteeing sunny weather, perpetual marital fidelity and personal happiness.

We are not certain last week’s billions will work. Don’t expect a quick fix, anything else will make you feel a whole lot better.

Remember America must make sure its creditors are happy. To do this they must stop borrowing or they must start taxing and growing less. David Rosenberg of Merrill Lynch calls it the age of frugality.

We may not save the week, or the month or the cycle outcome. Let’s expect the worst case...a very severe recession. The credit crisis cuts off lending at the pace of the past few years. Demand falls. The fall in house prices probably is leading to a fall in many prices. If the recession does not happen, we will feel better. If it does we will be prepared for it.”

**“Well, you could always take solace from our Prime Minister.”**

“Who?”

**“Mr Harper.”**

“Why?”

**“He said, ‘If we were going to see a meltdown, we would see it by now.’”**

“Good thing he’s running the government.”

**“Why’s that?”**

“He’s gotta lot of trapped taxpayers to fix his mistakes.”