

When the Going Gets Tough...

It is tough out there. The S&P 500 has declined 29.8% from the peak reached at this time last year. According to data provided by Myles Zyblock at RBC Capital Markets the current decline is in-line with the average 29.7% drop in the S&P 500 during other bear markets over the past fifty years. It is in times like these that fortunes are won and lost. We have witnessed major financial institutions with histories that go beyond a hundred years evaporate over a weekend. On the flipside, some are attempting to strengthen their presence and competitive position in major ways. As an example, this morning Wells Fargo bid \$15.1 billion for all of Wachovia, including its toxic liabilities. If successful, Wells will become the largest deposit taking institution in the United States. Wells Fargo has a reputation as one of the best managed banks in the world. Despite all of the doom and gloom, especially in the US Financial sector, Wells' stock price is actually up year-to-date.

Wells Fargo believes that any costs associated with writing down non-performing loans at Wachovia will be much more than offset by the opportunity that comes with doubling their retail banking presence in North America. Warren Buffet has also been very active in the past few weeks. First acquiring a major stake in Goldman Sachs, then acquiring a major stake in General Electric. He describes the current environment as an "economic tsunami", but he also has reminded us that "the time to be greedy is when others are fearful, and the time to be fearful is when others are greedy". These moves by Wells Fargo and Warren Buffet are not without risk but the risks have been weighed against sizeable rewards.

We have been asked whether or not an individual should be selling their investments in response to what feels like a continuous deterioration in the economic climate. We sincerely believe the answer is no. It could get worse in the short term for both the market and the economy but we don't think the system is broken. Stocks are currently on sale. We have reviewed historic price to earnings multiples for each company in the portfolio. Approximately half the portfolio is trading at decade lows on a price to earnings basis. That tells us that the expectation in the market is that the business climate will remain difficult for sometime to come. The difficult environment is getting priced into stocks.

The businesses we own in the portfolio continue to build their franchises during these trying times. In aggregate, we expect these businesses to emerge from the trough of the cycle stronger than when they entered. We are not infallible and neither are the managers that run these companies. There may be some that slip up and that is why we have a

diverse portfolio of around forty companies. So far, the financial results of the businesses we own suggest solid navigation through this period. The average growth in shareholders equity for the small cap fund has been approximately 8% over the past twelve months. It will get more difficult but we will get paid to wait. Over three quarters of the companies we own pay a dividend. Fifteen of these companies have increased their dividend over the past year. The dividend yield on the small cap fund today is 3.3%. To put this in context, five year Government of Canada bonds are currently yielding 3.06% and ten year Government of Canada bonds are yielding 3.67%.

An investment in government bonds is essentially risk free. Investing in equities carries significant risk, but this risk is not taken without potential reward. A Government of Canada bond pays a coupon but your principal cannot be grown like shareholders equity can. A stock that grows along with its book value growth at an average rate of 7% (a reasonable historic proxy) and contributes a 3.3% dividend yield would return approximately 167% over a ten year period. This compares to 43.4% if you invest in a Government of Canada 10-year bond today and reinvested proceeds at the same rate. If you are diversified by asset class and have a long term horizon now is not the time to sell your equities.

Inside the Fund

Richelieu Hardware, a company that distributes over 50,000 hardware related stock-keeping-units to over 38,000 customers in North America reported quarterly results yesterday. It grew earnings for the 51st consecutive quarter despite the very difficult macro environment. As a sign of the times, the stock has fallen 12% today on low volume despite growing earnings by 8% during the quarter and largely meeting expectations. Richelieu expanded into Western Canada during a difficult economic period in the 1990's. It has grown that business tenfold to become the largest distributor of its kind out west. It is now working hard to do the same thing in the US. It is developing a footprint in Florida during what may be the toughest housing market of our lifetime. It is stealing market share from leveraged competitors. It has no net debt and is growing through the use of internally generated funds. Richelieu expects that the footprint it is putting in place now will launch it from \$500 million in sales to over one billion in sales. Like Wells Fargo and Warren Buffet, Richelieu recognizes that it must seize the opportunities that develop in the midst of the chaos. We will do the same in managing your investments. When the going gets tough, the tough take calculated risks.