

How Things Change

Over the past year there have been extreme changes on so many fronts. In November of last year the front cover of India's national newspaper displayed a cartoon of an indestructible sacred cow in a superman costume celebrating the new found wealth brought by the great bull market. Fast forward less than a year and the Bombay Stock Exchange, like so many other exchanges, is trading at less than half of its value from a year ago.

There has been abrupt change in Canada. At this time last year, Research in Motion was reaching a new high on almost a daily basis. The price-to-earnings ratio was trading at a lofty 38.0x forward earnings compared to 12.5x today. In this letter at the time we highlighted the risks to owning the company:

"As a company becomes more expensive you would think that it would become less of a focus for most investors. However, the opposite is likely true in this case. As it [Research in Motion] closes in on Royal Bank as the largest publicly traded Canadian company, it has more and more influence on the direction of the TSX index. As a result, some fund managers will likely buy in to avoid the risk of having to explain underperformance if the stock keeps climbing. With the valuation soaring and weak-handed investors increasing their ownership, the stock is not without downside risk."

In our own province, we are also experiencing substantial change. We spent a portion of this week up in Edmonton touring several industrial facilities. During previous visits to Alberta's capital city we heard stories of scaffold workers making over \$4,000 per week as well as aggressive strategies for recruiting out of province and out of country labour. The tone of this trip was different, much different. The sharp decline in the price of crude oil is starting to have a real impact on Alberta's economy. During our visit to Edmonton, UTS announced that it would likely delay its Fort Hills upgrader and Suncor announced that they would reduce their oil sands capital spending plans by approximately \$3 billion in 2009. The slowdown in activity is having an impact on the local economy as business and consumer confidence erodes. At the start of October, Edmonton new home prices recorded a 5.7% drop year-over-year. It appears that after many years of grappling with inflation, inflation is now the least of Alberta's worries.

The outlook for most management teams has also changed drastically compared to a year ago. The CEO at Graco Inc. the US based maker of industrial paint

sprayers may have summed up the current environment best yesterday during Graco's third quarter update:

"It is a difficult planning environment, probably the most difficult planning environment that I've been associated with during my 20 years here at Graco"

-Patrick J. McHale, President and CEO, Graco Inc.
October 23, 2008

The deteriorating economy, violent commodity price drops and unprecedented exchange rate moves will also provide a change in market leadership. The thirty members making up the Dow Jones Industrial Average five years from now will be very different from the thirty members from five years ago.

Management teams that remain flexible will have the best chance to flourish in the future. Rick George, the CEO of Suncor and his team should be commended for their ability and their action to adjust quickly in their new reality. We understand their updated capital spending initiatives can be self financed at a \$60.00 WTI oil price.

The companies with the most flexibility are the ones with little or no debt. In the most recent business cycle some companies have strapped on debt at exactly the wrong time. We aren't immune to the downside of leverage but the portfolio as a whole is in very good shape. One way we measure the portfolio's financial risk is by calculating its debt-to-equity ratio. The higher the percentage, the higher the risk. During the bear market at the start of the decade the small cap fund had a debt-to-equity ratio of approximately 65%. Today, the debt-to-equity ratio for the portfolio is 40%. This compares to a debt-to-equity ratio of 60% for the market as a whole. We also have a reasonably large amount of cash in the portfolio at approximately 9.4%. Many of the companies in which we have invested have stockpiled cash.

With all of this change, it is sometimes difficult to keep the head from spinning, but know the following:

The portfolio is in sound financial shape. Valuations are closer to the bottom than the top. The companies in the portfolio are being led by seasoned management that are experienced in adapting to change. Also remember:

"Change always comes bearing gifts"

-Price Pritchett