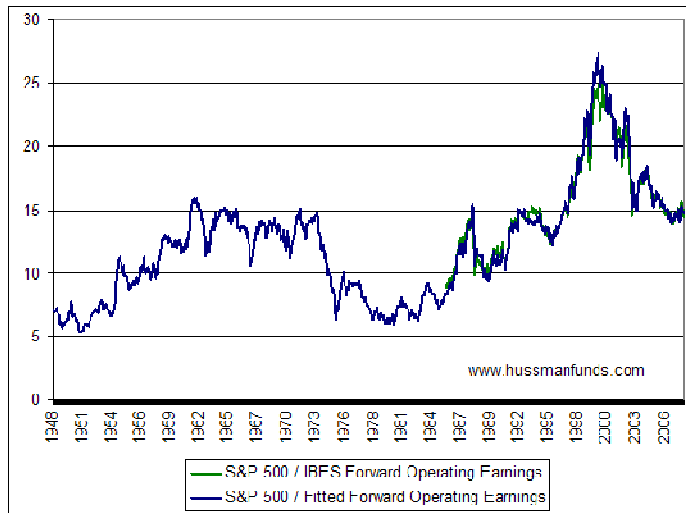


## Cheap or Expensive?

If we read through analyst reports or newspapers, we would receive differing opinions on whether the stock market is cheap or expensive. John Hussman helped by providing an analysis of the price to earnings ratio of the S&P 500 using forward operating earnings over the past 50 years to help answer this question. According to his research shown in the chart below, the average forward P/E of the S&P 500 is 12x. If we exclude the technology bubble, this average drops to 10.6x. Currently, the S&P 500 market is trading at 15x forward earnings while the S&P/TSX Composite is trading at 15.5x. Based on this information alone, the market looks expensive.

A different approach is to review the profit margins implied in these forward earnings estimates. The profit margin on the S&P 500 is approaching 11%. This is at a historical high. The average before the technology boom in the late 1990s was 8%. It becomes concerning when the historically high multiples are attached to high profit margin expectations. Our job as managers is to find those companies that have margins that are more reasonable and valuations that fully reflect normal levels. We have discussed our concern on the level of the market for a while. Our objective is to continue to find those companies within the market that are appropriately priced to provide a margin of safety if profit margins do decline to more normal levels.



## Inside the Funds

EnCana Corporation (ECA), a holding in our Balanced and Canadian Equity Funds, reported this week. Although management was very pleased with its results, the market was unhappy. It is most likely because of the increase in 2010 capital expenditures to \$5.0 Billion which exceeds the cash flow projected for the year.

ECA is known as a company with a very clear strategy. It strives to find low cost assets while ensuring the balance sheet is managed conservatively. Historically, EnCana has done this by entering natural gas plays early and paying substantially less for its land than late arrivers. An emerging play in North America is the Marcellus shale in the Northeast United States. EnCana reviewed the area years ago and realized there was a lot of natural gas in the region, but management was concerned with the lack of pipelines and processing facilities. EnCana determined this would not qualify as a low cost play and decided to pass. The issues it raised are front and center today. The management has continued to focus on areas with significant infrastructure which allows its costs to remain low.

Hedging of natural gas prices has been used to protect ECA's capital expenditures program. According to EnCana, the best way to produce natural gas at low costs is to continue drilling through all types of markets rather than ramping up a drilling program during good times and scaling it back in bad times. The ability to lock up fit for purpose rigs with three to five year contracts allows ECA to negotiate better prices and engage the best rigs.

At the investor day in March of this year, ECA's CEO stated they will double their production of natural gas in the next five years. The question on everyone's mind was why would it increase production and spend so much capital at these low natural gas prices? EnCana indicated on its most recent conference call that it can cover its cost of capital (approximately 9%) at \$4.00 natural gas prices. Current Nymex is around \$4.50; however, the company has 60% of its 2010 production hedged at \$6.00 and 33% of its 2011 production hedged at an average price of \$6.30. It is earning a very respectable return at these low natural gas prices.

EnCana believes 2010 is a transition year. It believes the long term gas price is closer to \$6, so the company is positioning for the next five years by getting the production up in anticipation of higher prices. EnCana has 23,000 drilling locations which provide an inventory of 18 years of drilling. ECA would like to start bringing this value forward by spending a bit more this year.

In meeting with the company this week, we learned the increase in capital expenditures will not breach its stated target of having a debt to total capitalization ratio below 35%. ECA continues to run with a conservative balance sheet. The strategy is to increase production, which will increase cash flow and ultimately dividends.