



## KEEP IT REAL

Often when I hear the term “keep it real,” it leads to cynical thoughts. It’s a term favoured by Hollywood starlets and heartthrobs to announce to the world (through a publicist) that they are not caught up in the ether of celebrity, but have a normal down-to-earth existence. My thoughts in response: get real.

However, here at Tetrem, “keep it real” continuously pops up in many of our discussions about the capital markets, the economic downturn and stock picking. Over the past few months it has become clear that we are in the midst of a global economic slowdown due predominantly to the bursting of a vast credit bubble and the ensuing deleveraging of the financial and economic system. It is as if someone turned the lights out on the global economy in the wake of September’s failure of Lehman Brothers, which has given rise to a negative feedback loop of terrible economic data, earnings results and declining confidence. The cocktail of choice in today’s market environment is uncertainty mixed with fear.

It does not pay for an investor to ignore economic realities when making investment decisions – doing so could lead to disaster. Facing an onslaught of grim economic news, investors must choose between one of two distinct alternatives. One is to liquidate all equities and hide in perceived safe assets such as cash or government bonds, while waiting for the economic clouds to part. The second is to take advantage of the fear and uncertainty by making carefully reasoned investment decisions to purchase bargains. We are compelled to choose the latter.

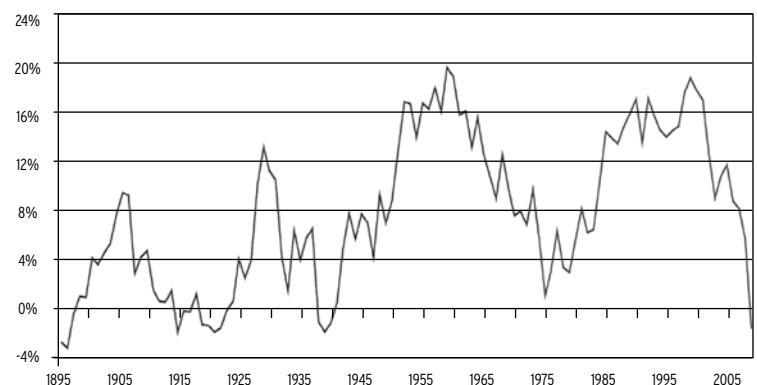
To help guide our investment decision process through these times we have to balance the reality of a difficult environment with our contrarian investment philosophy. We now know that equity markets had their worst losses in 2008 since the Great Depression year of 1931. There was virtually nowhere to hide as all industry sectors declined in value, though with 20/20 hindsight it is clear how we could have done more to preserve capital. However, as investors, we need to carefully assess the situation as it is, not as it was. It makes absolutely no sense to invest for the future using a rear view mirror. The first order of business in today’s market is to control the fear-driven emotional response to yesterday’s stock price movements. Many investors are hurting from negative 10-year returns on the S&P 500, which may lead them to conclude equities should be avoided. However investors would do well to pay heed to the following fact: over the past 100+ years, whenever 10-year returns dropped below zero, including the 1930s, it proved to be a good time to be invested [Figure 1]. All of the historical low points in the market were accompanied by feelings of regret and extreme pessimism about the future.

No one knows the duration or the magnitude of the present economic downturn. Government authorities are attempting to re-inflate the system through aggressive monetary and fiscal stimulus. History tells us that the policy actions are likely to be effective, but we don’t know when or to what extent. In the meantime, the recession will linger and deleveraging will continue. Uncertainty is high, but there are excellent investment opportunities available to those with a long-term outlook and the courage to take advantage of them.

Picking value stocks is more straightforward today than it has been in many years. With so many fundamentally cheap stocks in today’s market, triage has become paramount. To start, we are clear on what we want to avoid, most notably companies that are over-leveraged and have flawed business models. When bubbles burst, the damage lasts for years – witness Nortel filing for bankruptcy a full eight years after its stock price peaked. Companies that are the children of the credit bubble have survived by being thrown a life-line of easy and cheap credit over the years. Many are now at risk of failing. We are therefore avoiding companies that have too much debt, particularly when the debt is combined with a business model that requires positive operating leverage (increasing sales) to work. With the high number of excellent investment opportunities we are seeing in this market, there is no need to take on the risk of investing in companies with solvency issues. To do so would smack of speculation.

We first started using the term “keep it real” when reviewing sell-side earnings estimates for companies. To us it seems that many

**U.S. Equity Rolling 10-Year Compounded Total Returns (1895-2008) [Figure 1]**



Source: UBS





analysts have been slow in adjusting earnings estimates to the new economic reality. We've combed through the companies in all of our portfolios to find situations where expectations are too high and the risk of disappointment is great. If we believe that a stock's valuation does not adequately discount lower expectations, we sell the shares. This analysis is applied to all prospective additions to the portfolio. We have a long list of companies that we hope to buy once expectations are washed out and valuations become even more attractive.

By numerous measures, the valuation spread between the cheapest companies and the overall market is as wide as it has been in over 50 years. If this isn't the buying opportunity of a generation, I'm not sure what is. We are focusing our research efforts on companies whose relative cheapness is extreme. Typically, value stocks have their best relative and absolute performances coming out of an economic recession as stress dissipates. We have no reason to believe that it will be any different this time. If anything, we believe that the relative outperformance will be wider than average owing to the extremely wide level of valuation dispersion.

In addition to "keeping it real," we are keeping it simple. We are looking for companies that are cheap relative to book value and cash flow, and are in businesses that we understand. We like the support and returns of dividends, though we aren't necessarily targeting companies whose shares offer the richest dividend yields. Unusually high yields often signal an imminent dividend cut. We see a greater margin of safety in companies with reasonable dividend payout ratios. In these cases, the dividends are likely to prove sustainable and be increased as the economy stabilizes.

We have no issue investing in companies that are facing declines in operating results. The fact of the matter is that if a company is trading below book value, the near-term earnings results aren't going to be pretty. We want to make sure that the long-term business fundamentals aren't impaired or, in other words, that the decline in profitability is temporary, not permanent. This goes

to the core of our investment philosophy and is how we find the best investment opportunities. We are looking for companies that are cheap on what we call normalized earnings (i.e. earnings that would occur in a normal economic and business environment). The current economic weakness is not normal and it is not permanent.

A related theme we are looking to exploit is what we call "corporate Darwinism." Not only do we want companies where the underlying business is not impaired, we want companies that will take advantage of the impairment of their competitors. We are looking to invest in companies that can emerge from the downturn with earnings power that is enhanced by virtue of weaker competitors going out of business. This is the flip side of avoiding companies that appear doomed; we want to own those companies that will not only survive, but thrive. Our ideal investment opportunity is one where the company solidly fits all of the above criteria. Most of the time this is a tall order. But in today's dislocated market, we have found several such companies, and believe we will uncover others.

The current economic issues are severe but as a society we will eventually exit this period stronger than when we went into it. The fiscal and monetary stimulus will dampen, but will not negate, the blow. It is conceivable we are currently in the worst part of the economic contraction and the fog will lift as 2009 progresses. For too many years we have been living with increasing debt loads and easy credit; the idea of saving for a rainy day had become a quaint afterthought. Not any more. To get through this period, our society will have to make a 180 degree turn away from a culture of entitlement and towards more puritanical values of thrift and hard work. Fortunes can still be made in business, however it is less likely to be through financial engineering and more likely to be through creativity, ingenuity and perspiration. Through the ages, civilization has progressed and expanded in the face of adversity and it will continue to do so. It's just that there may be fewer private jets and McMansions to go around. This is the new reality.

**Daniel A. Bubis, CFA**

President and Chief Investment Officer

## CANADIAN MARKET REVIEW

The reality that we are in a recession hit home as most stocks fell during the quarter. Certain sectors fell harder than others, as stocks that had been perceived as relative safe havens in the first half of the year got pummeled. This applied to both the banks and to commodity-related stocks, such as fertilizers and energy. Volatility was especially acute in October and November when, for example, in a single gut-wrenching day (November 13), the index fell

nearly 5% intra-day only to rally 9% from the low. It seems clear the market was trading more on emotion than on reason.

For the quarter, Tetrem's Canadian Equity Value Composite fell 17.7% compared to the S&P/TSX Composite's decline of 22.7%. Broadly speaking, our underweight positions in banks and fertilizers helped relative performance, as did our overweight stance in gold stocks. Partly offsetting this, our overweight position in energy



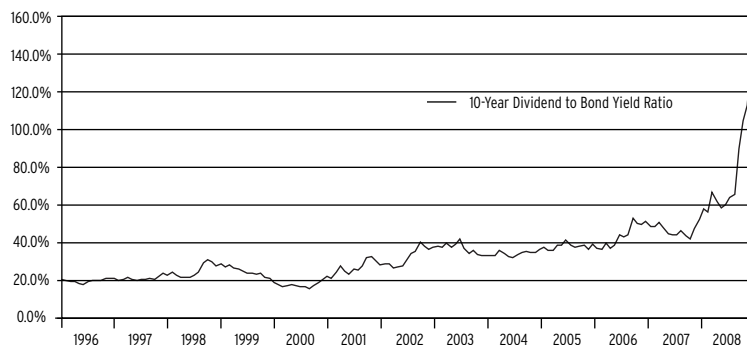


names hurt. Given the volatility in the quarter, the Canadian portfolio's turnover was relatively high. We sold stocks such as Shoppers Drug Mart, Teck Cominco and Yellow Pages Income Fund and deployed the proceeds into beaten-down names such as ING Canada, Bombardier and Canadian Tire.

We remain cautious on the banks as a group. Against the backdrop of a slowing economy and higher unemployment, banks will need to take higher provisions for credit losses. We believe normalized returns on equity are likely to fall, in which case the group is unlikely to outperform. That said, we are starting to see the emergence of good value among some of the stocks. We recently initiated a small position in Bank of Montreal (BMO), which presently has an attractive dividend yield in the 8% range. The issues specific to BMO are well understood and appear to be discounted by the market. This allowed us to buy the stock below book value, a good indicator of trough valuation in previous bear markets.

Portfolio holding WestJet (WJA) has shown strength of late compared to its competitor Air Canada (AC.A). We have traditionally avoided airline shares because they have been notorious for destroying capital. In our analysis, WestJet is different. The company has been chipping away at Air Canada's dominant position for years thanks to a much stronger balance sheet and a lower cost structure that give it a persistent competitive advantage over its larger rival. As the recession and subsequent recovery play out, we believe the company will continue to gain market share and should ultimately prove more valuable to equity investors.

TSX Dividend Yield vs. 10-Year Government of Canada Bond [Figure 2]



Source: Tetrem Capital Management, Thomson Baseline, Compustat

Our outlook on the markets is balanced. Prudence is warranted to the extent we have been in an environment characterized by fear, which can drive down stock prices even when a company's prospects are good. Offsetting this, valuations of numerous equities have become compelling for those willing to take a long-term view, and we are excited about the individual stock opportunities we have uncovered. Many blue-chip stocks have dividend yields that are higher than yields on the 10-year Government of Canada bond (now at 2.8%), which suggests that the stocks offer uncommonly attractive relative and absolute values [Figure 2].

**Alec MacIsaac, CFA**  
Investment Analyst

## U.S. MARKET REVIEW

2008 will go down as an historic year for the U.S. stock market and will be a measuring stick for years to come when comparing future economic contractions and market declines. Overall, the Tetrem U.S. Equity Composite fell 23.2% vs the S&P 500's decline of 21.9%. Not surprisingly, we had a somewhat cautious view during the latter part of the year and were holding higher than normal cash positions, which helped performance. We largely avoided the carnage in the financial services sector, starting the period underweight, a stance that changed to approximately market-weight as we purchased some shares at bargain prices during the quarter. While some of our largest holdings such as Johnson and Johnson (JNJ) and Barrick Gold (ABX) did relatively well, it was not enough to offset weakness in other areas. Our overweight stance in the energy sector, which had helped performance during the first half of the year, suffered a decline during the market sell-off.

During the quarter we sold our positions in Sony (SNE), Apollo Group (APOL) and Qualcomm (QCOM) among others. We also added several new names, including Best Buy (BBY), Intel (INTC) and Goldman Sachs (GS), names that all fit our "corporate Darwinism" theme. Best Buy has a strong balance sheet, strong cash flows and a great brand, all of which are contributing to increased market share over its weakened rivals. This past week we witnessed the liquidation of major competitor Circuit City. We estimate that this could enable Best Buy to generate approximately \$0.50 of incremental earnings per share over time, which in turn could increase the stock's price by \$7-8 using a reasonable 15 times multiple.

Despite an economy that is likely to get worse before it gets better, the investing landscape is the most exciting it has been in recent





memory, as we are finding a number of value opportunities amid the financial stress. It is clear to us that the global authorities will do whatever it takes to provide enough monetary and fiscal stimuli for the economy to regain its footing. Confidence, or lack thereof, is the one critical issue still weighing on the outlook. American investors and homeowners have witnessed tremendous wealth destruction, and it will take time to repair the collective psyche. However, as contrarian value investors, this is exactly the time we like to be buying stocks. As F.D.R. stated in his 1933 Presidential inaugural address, "the only thing we have to fear is fear itself." We are not sure when confidence will return to the investing public, but we have conviction that we are buying strong businesses at attractive prices. This combination should deliver compelling returns for those with a long-term view.

#### Aaron Clark, CFA

Vice President, Investments

#### ABOUT TETREM

Tetrem Capital Management offers money management services to institutional and select high net worth clients. Our investment mandates are focused on Canadian and U.S. equities, rooted in our long-standing contrarian value style and tailored to the specific needs of our clients.

Investing is our profession and we are committed to doing it well. Our experienced team's primary focus is seeking out and investing in undervalued companies. For each of our investment mandates, we utilize quantitative and fundamental analysis in our rigorous stock-selection process, with a focus on preserving and growing our clients' assets.

For more information about Tetrem Capital Management please visit our website, [www.tetrem.com](http://www.tetrem.com), or call and ask to speak with us about our investment services.

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#### TETREM'S CANADIAN EQUITY MANDATES

	Annualized Returns to December 31, 2008					Calendar Year Returns				
	Q4 2008	1 year	3 year	5 year	10 year	2008	2007	2006	2005	2004
Tetrem CDN Equity	-17.72%	-28.27%	-6.83%	4.06%	9.91%	-28.27%	3.18%	9.27%	31.13%	15.05%
Tetrem CDN Equity Plus	-19.47%	-31.38%	-7.19%	3.65%	9.76%	-31.38%	6.10%	9.80%	29.88%	15.24%
S&P/TSX	-22.71%	-33.00%	-4.80%	4.16%	5.34%	-33.00%	9.83%	17.26%	24.13%	14.48%

#### TETREM'S US EQUITY MANDATES

	Annualized Returns to December 31, 2008					Calendar Year Returns				
	Q4 2008	1 year	3 year	5 year	10 year	2008	2007	2006	2005	2004
Tetrem US Equity	-23.17%	-39.16%	-7.77%	0.94%	7.92%	-39.16	8.32%	19.04%	15.22%	15.92%
Tetrem US Equity Plus	-22.93%	-39.11%	-6.82%	2.70%	7.81%	-39.11	11.49%	19.17%	22.64%	15.17%
S&P 500	-21.94%	-37.00%	-8.36%	-2.19%	-1.38%	-37.00	5.49%	15.79%	4.91%	10.88%

#### TETREM Performance Disclosure

Prior to June 1, 2004, performance returns were owned by Assante Asset Management Ltd ("Assante"). Tetrem has concluded that these returns meet portability requirements and as such, have been linked with Tetrem's returns for the sole purpose of providing supplemental information to the Tetrem's Composite Performance Presentation. This information is provided to present a longer track record using records available to Tetrem and may have limited usefulness.

**Canadian Equity and U.S. Equity** returns from January 1, 1997 to December 31, 2003 are based on an audited equity-only (excluding cash) composite of all segregated accounts and are owned by Assante. Performance from January 1, 2004 to December 31, 2004 is based on an unaudited equity-only (excluding cash) composite of all segregated accounts. The calculation of performance returns excludes expenses and is based on a monthly valuation using the Modified-Dietz methodology. Returns from January 1, 2005 to December 31, 2008 are prepared and presented in compliance with Global Investment Performance Standards (GIPS®).

**Canadian Equity Plus** returns from January 1, 1998 to May 31, 2004 are calculated using the audited NAV per share of a representative account within the composite. The NAV per share excludes management fees and is net of operating expenses. Performance returns for this period are owned by Assante. Returns from June 1, 2004 to December 31, 2008 are prepared and presented in compliance with GIPS.

**U.S. Equity Plus** returns from January 1, 1998 to May 31, 2004 are calculated using the audited weekly NAV per share, closest to month end, of the sale account within the composite. Performance returns calculated include operating expenses, but exclude management fees. Performance returns for this period are owned by Assante. Returns from June 1, 2004 to December 31, 2008 are prepared and presented in compliance with GIPS.

From June 1, 2004 to December 31, 2008, Tetrem has prepared and presented composite performance in compliance with GIPS. Tetrem has been verified by an independent verifier for the periods from June 1, 2004 to December 31, 2007. Copies of the verification report and a full list of composites are available upon request.

Tetrem's mandates are available to institutional investors such as pension plans, group retirement plans and foundations and certain individual investors who meet specified investment criteria. The mandates' performances are not guaranteed, the values change frequently and past performance may not be repeated.

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