

MARKET COMMENTARY

Tetrem Capital Partners, July 2004

Not a Target Rich Environment

Top Gun, the 1986 action movie about U.S. Navy fighter pilots spawned a number of new trends. Tom Cruise and Val Kilmer became major Hollywood stars, flight jackets became fashion accessories, and many people, especially impressionable young male university students, incorporated a vernacular based on lines from the movie. One line that saw more than its fair share of recycling was “target rich environment.” This military term describes an environment rich in enemy targets, which in the movie had the double meaning describing a certain social scene. Other than donning the odd cheesy flight jacket, portfolio managers don’t share too many similarities with fighter pilots. However, like fighter pilots one thing that does bring a smile to each our faces is a target rich environment.

For equity portfolio managers, the primary target is a stock that offers an attractive investment opportunity. As value managers, we at Tetrem particularly prize well priced investment opportunities. For us, a target rich environment is one that, in the words of John Templeton, has stocks with prices that can be bought “at the point of maximum pessimism.”

When pessimism abounds, prices reflect reduced expectations and bargains blossom.

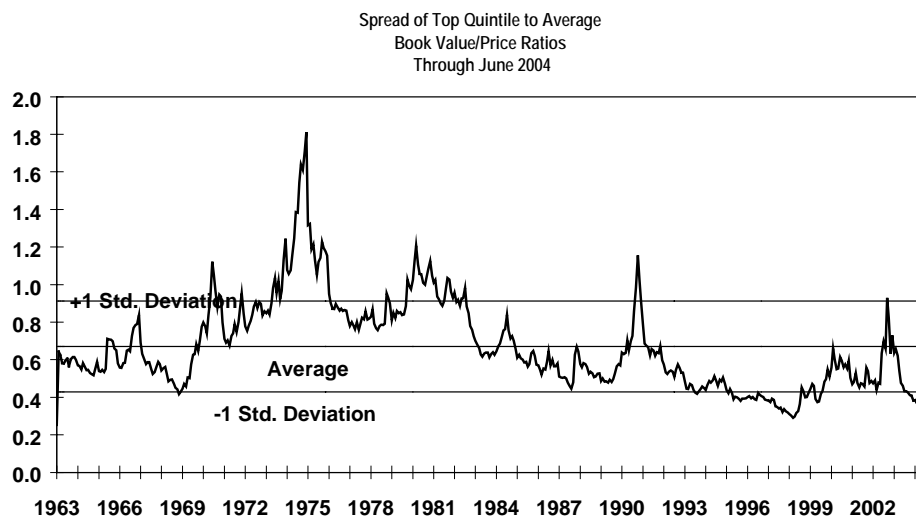
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Pessimism can envelop the stock market as a whole, a particular industry, or an individual company. It really doesn’t matter. The more pessimism, the more distress around stock prices, giving rise to a target rich environment for a value investor. For the value investor, the reality is that today’s stock market lacks a target rich environment.

At the time of writing, we feel that the stock market is in the upper end of a fair value range. While this may seem ok, it’s not comforting to us. Where is the opportunity in a fairly valued market? Investors should generally prefer an undervalued market when putting money to work. A cheap market not only offers greater upside, it also limits the downside risk. Fortunately, doing our job successfully does not require us to predict the direction of the market. We try to make money for our clients by identifying investment opportunities, primarily through individual stock selection.

The attached chart compares the book-to-price ratio of the cheapest quintile of stocks to that of the total universe of North American stocks.

This chart can highlight where value opportunities reside. It provides one measure of the degree to which securities are mis-valued in the stock market. For the past three quarters, the value opportunity has been at historically low levels. Of course, we’d like the opposite to be the case. Value managers love to see the value opportunity shooting through the roof providing us with a target rich environment.



Source: Bernstein Research



Today's environment makes it tough to find compelling new investment opportunities. Everyday, we identify stocks that have reasonable upside, so long as the economic environment remains benign and bull market conditions persist. However, we do not rely on such

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assumptions, and therefore we also analyze what would happen if the investment environment got a little tougher. On analysis, we find that many of these same stocks with a reasonable upside have a healthy dose of downside risk, that overall makes them unappealing at their current price levels. For an investment to work out, the price paid is of paramount importance.

One of the reasons that there are so few good opportunities out there these days is that investors have become focused on the very short-term, all but ignoring the problems that will manifest themselves further down the road. The average professional investor is fixated on investment results over the next three months, and if he or she is in a particularly long-term frame of mind, perhaps six months. Near term orientations have bred a lot of complacency, with investors paying

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insufficient attention to most of the long-term economic imbalances that continue to exist. High debt levels and a persistent trade deficit are two major imbalances that the world's largest economy has not even begun to deal with. The market has been driven by monetary and fiscal stimuli, which now are close to running out. As 2004 moves forward, and the U.S. Presidential election becomes history, a less distracted market will be forced to wonder where the drivers for future economic and earnings growth will come from.

There are enough questions about the sustainability of the current economic recovery that we fully expect to see the return of pessimism to the market. Investment controversies surrounding individual companies will provide attractive buying opportunities in the not too distant future. In the mean time, we continue to hold stocks that we like. Our cash balances have recently gone up slightly given the drought of new opportunities and our disciplined selling of shares that have exceeded "fair value."

We have placed additional capital in specific investments, which we believe contain unrealized value that has not been recognized by the markets. The energy sector is one such example. We believe that an inflection point has been reached, and that energy prices will remain at levels higher than have existed throughout most of the 1980s and 1990s.

Terrorism aside, oil has also become much scarcer at a time that demand is accelerating because of the industrialization of China and India. As recently as 1995 China was a net exporter of oil; today it is importing over 7 million barrels per day. Regardless of near term concerns about a Chinese economic slowdown, that import figure will only go up over the balance of the decade.

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High and volatile oil prices are not good for the industry as they run the risk of hurting the consumer. Therefore, as investors in the energy sector, we actually appreciated the recent pull back in the price of oil from over \$42 per barrel. If the market becomes convinced that oil prices can stick at the \$30 range, the energy sector will be revalued higher. While there will be times where this sector struggles, we are happy to be invested in it, in light of our long-term outlook and current share price levels.

Each day we run our reports, read the news, and search out new investment opportunities. You could say that we are roaming the skies in search of targets. It's not the most exciting time to be an investor, but we are poised to go after attractive investment opportunities when they inevitably arise. Our investment portfolios are well positioned for tougher economic climates that may lay ahead, while continuing to profit from current global economic growth thanks in part to our exposure to the energy sector.

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