



## WHAT IS VALUE?

*"Price is what you pay. Value is what you get."*

- Attributed to Warren Buffett

It has been an extremely difficult time to be an equity investor in a market environment rife with fear. Many investors are scared of the potential for an economic Armageddon triggered by the ongoing global financial crisis and equities have suffered accordingly. The shares of many good companies have fallen below Tetrem's "pessimistic case" price levels, making capital preservation a significant challenge.

There is no question that we are in the midst of a recession, the only real questions are how deep and how long? While no one can answer these questions with any reasonable level of certainty, we do know that much fear of economic downside is already reflected in current share prices. Uncertainty is the friend of all long-term investors as it creates value opportunities that simply do not exist when the prevailing perception is that the future is bright.

We are finding excellent investment opportunities in the current market, unlike anything we have seen in nearly 20 years as professional investors. Our focus has always been on investing in companies that offer excellent value characteristics. By that we mean we want to own shares of companies that are trading at a discount to their intrinsic values, a condition we are now seeing in the common shares of most companies.

Today, more than ever, our focus is on high quality companies, not necessarily the cheapest ones that can be purchased on the stock exchange. Given that we are in the midst of a financial crisis where credit has become extremely scarce, we want to own companies that are rock-solid financially and have strong competitive positions. We are putting extra time into balance sheet analysis and are targeting companies with low levels of debt and high levels of free cash flow. We want to own the companies that are best-positioned to survive and prosper through the current economic dislocation. Eventually economic activity will normalize and we believe the best investment opportunities will prove to have been those companies that were able to invest in their businesses during the downturn and gain market share from weaker competitors.

Coming out of the 2002-2003 market bottom, low quality stocks performed the best. In 2003, investors were actually hurt by holding high quality companies in their investment portfolios. The recession at the turn of the century was relatively mild by historical standards and therefore did not properly "cleanse" the economy of over-extended, weak companies. When central banks lowered interest rates, effectively throwing these highly-levered companies an economic lifeline, their shares surged. We do not think that many of these companies will be

as lucky this time around, which explains our bias toward higher quality value stocks. In a market full of cheap stocks, cheap can be a trap. All investors have been reminded of this lesson one way or another as the current bear market has ground down over the past year.

We could be wrong. Lower quality companies may not be the value traps that we think they are. Some will undoubtedly survive and lead the market higher (but where to first?). However, to us at Tetrem, they are just not worth the risk of potentially going to zero. In our opinion, buying these companies is more speculating than investing. We'd rather pay a small premium for a company that has a strong financial and competitive position. By these measures our current U.S. and Canadian equity portfolios are among the higher quality that we have ever managed and they are likely to become even higher quality in the coming months.

Having a portfolio of financially strong companies geared towards economic growth makes a lot of sense to us, especially when many of them are trading at historically low valuation levels. In the twentieth century the world survived many potentially debilitating socio-economic and political events, including a number of recessions, the Great Depression, a flu pandemic, communism, fascism, and two world wars. During some periods, economic activity contracted, but the overwhelming trend was one of growth accompanied by increasing standards of living. This time is not different.

Tetrem managed portfolios have not performed as well as we would have liked or expected over the past few months. It is not because we have a portfolio of low quality companies or ones that are overvalued - the opposite is the case. The issue in our Canadian and U.S. portfolios is that our companies stand to benefit disproportionately from economic growth. As concerns over the economy have moved to the forefront, the share price of any company that is levered to economic activity has been harshly punished. For instance, our investments in the energy sector were hit hard in the third quarter. We continue to believe in the long-term secular underpinning of our energy investments and share prices offer compelling upside over the next three to five years. In many ways the long-term opportunity may be better today for the energy sector than it was just three months ago when oil hit \$145: with lower energy prices investment in the global energy infrastructure is set to decline in 2009, which should in turn lead to bottlenecks and sharply higher prices as economic activity rebounds. The rate of production declines from existing energy reservoirs continues to accelerate globally. Now is not the time to reduce capital investments in energy exploration and production, including the development of alternative energy sources, but it will happen.





TETREM QUARTERLY REVIEW

It pays to remember that stock markets lead economic activity. While no one rings a bell at the bottom of a bear market, share prices tend to trough three to six months prior to the bottom of an economic recession. Value stocks have their best relative performance coming out of bear markets. This makes sense as value stocks are, by definition, priced for low expectations and have strong leverage to an upturn in economic activity.

All of us on the investment team are sticking with our discipline by focusing on the upside and downside risk of each company we consider. In a highly volatile market, we view our flat organizational structure as an advantage as it allows us to act quickly as opportunities come our way. We have confidence that our patient and contrarian value approach will allow us to invest in high quality companies that will, over time, deliver continued above-benchmark returns for our clients.

**Daniel A. Bubis, CFA**  
President and Chief Investment Officer

**US MARKET REVIEW**

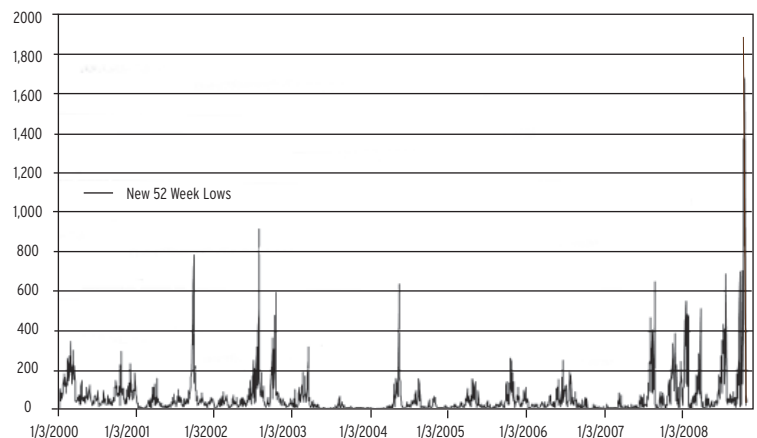
What a quarter. The third quarter of 2008 will go down as an historic time for U.S. financial markets as the ongoing deleveraging in the financial system resulted in some high profile casualties and forced mergers of financial institutions, some of which have been in operation for well over 100 years. The credit bubble that had been forming for more than a decade was characterized by falling interest rates, which led to easy credit and an increase in leverage in the system. That bolstered the value of many asset classes from real estate, to commodities, to emerging market equities. As the credit bubble deflates, we expect to experience a long period of deleveraging. There is no quick fix and it can really only be healed by one thing, time. That said, the depth and duration of the current recession and bear market will be influenced by the speed and magnitude of government actions. In an attempt to soften the blow, the U.S. and other governments have undertaken a number of measures, mostly reactionary, aimed at providing liquidity to the system. The recent actions of a coordinated global cut in interest rates along with capital injections into the banking system are steps in the right direction to help unclog the credit markets, but more policy actions may be needed.

During the quarter, the exploding credit crisis caused serious collateral damage to all but a few stocks, sectors, or asset classes. The selloff led to a huge spike in the number of U.S. companies hitting new 52-week lows [Figure 1]. The number is much higher than that of previous market declines, which attests to how widespread this one has been. The Tetrem U.S. Equity mandate was down 13.0% during the quarter compared to the 8.4% decline in the S&P 500, primarily as a result of our underweight position in the financial sector and our overweight position in energy. We avoided nearly all of the high profile disasters in the financial services sector but were exposed to AIG. Year-to-date ending September 30, the U.S. Composite fell 20.8% vs the index's decline of 19.3%.

The second quarter of 2008 had experienced some of the largest performance dispersions on record between financial and energy stocks, with the former down 30% and the latter up 30%. Conversely, in the third quarter, most of that crowded, momentum-based trade unwound, which led to one of the largest reversals on record as many energy stocks were down 20% or more while many financial stocks

increased over 20%. On July 16 we saw the fourth largest one-day rally ever in financial stocks. Strong rallies like this are not unusual in a bear market, and it proved to be short lived. We used the rally to sell some financial stocks that we had incrementally increased earlier in the quarter and subsequently used the proceeds to build up positions in the energy sector, which had suffered sharp declines. We saw good value in the energy names, but we underestimated the extent to which global margin calls would lead to forced selling, which in turn caused many energy stocks to blow through historical valuation lows. Volatility increased during the quarter and has accelerated to even higher levels in October, historically a month in which market bottoms have been formed.

**NYSE - COMPANIES HITTING NEW 52 WEEK LOWS (Figure 1)**  
Data Through Oct. 20, 2008



Source: Bloomberg, Tetrem Capital Management

So where do we go from here? As we discussed in the second quarter we have been actively researching many stocks in the most distressed sectors so that we are prepared to purchase them as prices fall to levels that meet our strict risk and reward criteria. An example of this is State Street Corporation (STT). We had done our fundamental research on the company and were prepared to buy it at a price about 20% below where





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the stock had been trading for the past few months. The low entry price we had set provided a good margin of safety, allowing for strong upside potential relative to the downside risk. The extreme market volatility created an opportunity for us to purchase the stock at a price that was below a nine times forward earnings multiple, a valuation level never experienced by this company. This is one example of the market bringing a quality financial stock to an attractive buy level. We continue to look for similar opportunities, but believe that a sustained recovery in the earnings and the stocks of most financial stocks is still a ways off. We are therefore cautious on the sector as we feel that the fundamental outlook is still quite challenging and valuations on aggregate do not reflect this. However, given the government's apparent willingness to

address the issues through policy measures, we have likely seen the lows for the sector. Unfortunately we may have seen the near-term highs as well, all in a span of two months.

We expect that many high quality companies will emerge from the current turmoil stronger and operating in a less competitive environment as capital exits their industries. We are researching and monitoring a large number of stocks closely, looking for them to hit levels where we feel the margin of safety is large enough to tilt the potential reward solidly in our favour.

**Aaron Clark, CFA**  
Vice President, Investments

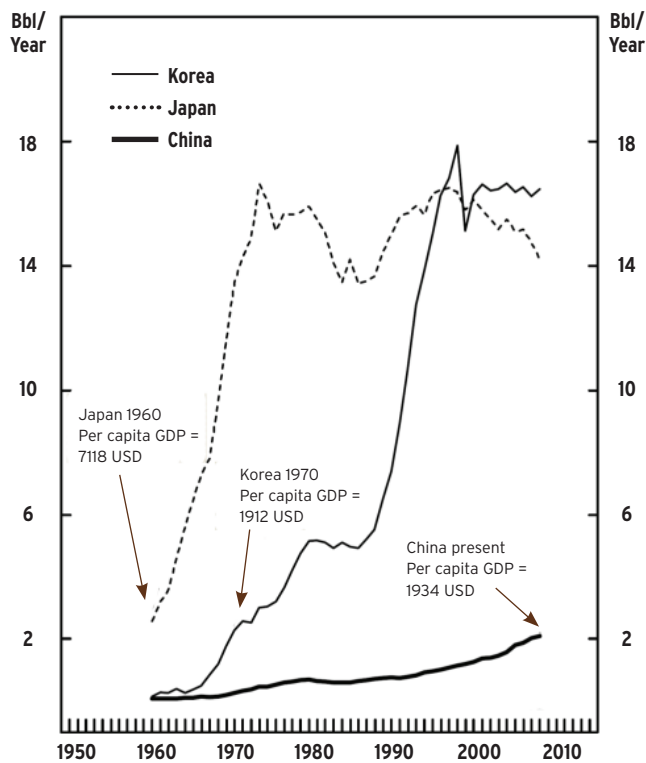
**CANADIAN MARKET REVIEW**

Over the summer a confluence of factors hurt sentiment in equities, and we are now indisputably in a bear market. Few investors still believe that global growth might "decouple" from a soft U.S. economy, and commodities have fallen in price as the possibility of weakening global demand has gained credibility. This had negative implications for the resource-heavy Canadian market, which fell 18.2% in the third quarter. Tetrem's Canadian Equity Value Composite fell a similar 16.3%. The year-to-date numbers ending September 30 are also both negative, with Tetrem's Canadian Composite down 12.8% vs the index at 13.3%. Relative performance in the quarter was helped by our longstanding avoidance of erstwhile high-flying heavyweights, Potash Corp of Saskatchewan and Research in Motion, both of which fell hard. On the negative side, our overweight position in energy detracted from near-term returns as did our underweight position in financials.

Although the direct impact of the credit crisis on Canadian banks and insurance companies appears manageable, there is no question investors are watching carefully for potentially negative indications. Canadian financial stocks have sometimes seemed like beacons of strength relative to their global counterparts, with blue-chip names such as Royal Bank and Manulife Financial rising during the quarter. [We must emphasize that the situation in October is fluid - at the time of writing Canadian insurers have fallen in sympathy with those in the U.S.] In the case of banks and other lenders, it appears Canadian balance sheets are generally cleaner than those of their U.S. counterparts, which are suffering from sub-prime indigestion resulting from too-easy lending standards in the face of a highly-levered consumer. We at Tetrem are on record as being concerned about a cyclical credit contraction and relatively high valuation of the Canadian banks on aggregate. Partly offsetting this, it is undeniable that Canadian banks pay attractive dividends that are likely to grow. During the quarter, we sold bank shares into strength and bought them back on subsequent weakness, a reflection of our price discipline in a volatile stock market. We remain underweight financials and are monitoring fundamentals and prices very closely for potential opportunities.

On the energy front, the rapid snap-back in crude oil from over \$140 to below \$100 [and subsequently to the \$70 range] hurt our energy names. When oil was peaking in July, the market didn't believe it was sustainable. Energy stocks were trading in a range that reflected roughly \$80 crude, which we believed provided an adequate margin

**OIL CONSUMPTION PER CAPITA (Figure 2)**



Per capita GDP is measured in 2000 U.S. dollars.

Source: BCA Research





## TETREM QUARTERLY REVIEW

of safety. We did not foresee the degree to which the stocks would fall relative to their underlying commodities. Many stocks now reflect a much lower price of crude and natural gas than we believe can be sustained. If oil stays below its marginal cost of production, estimated to be in the \$75-\$80 range, production will fall off and the commodity prices should rise to a level that allows companies to profitably engage in new projects. The timing is uncertain - a cold winter would help - but we believe the underlying growth in global demand for these depleting resources will ultimately trump any short-term fluctuations, and patient investors will be rewarded. Look, for example, to how oil consumption grew rapidly in Japan and Korea as their economies developed [Figure 2]. This provides a possible template for what we might expect from China, which has a long way to go before attaining "developed" status. Given our long-term view, the prospects for energy stocks remain very attractive.

**Alec MacIsaac, CFA**  
Investment Analyst

**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 September 30, 2008						Calendar Year Returns				
	Q3 2008	YTD	1 year	3 year	5 year	10 year	2007	2006	2005	2004	2003
<b>Tetrem CDN Equity</b>	-16.34%	-12.81%	-16.27%	0.15%	10.78%	13.08%	3.18%	9.27%	31.13%	15.05%	25.48%
<b>Tetrem CDN Equity Plus</b>	-15.47%	-14.78%	-16.69%	0.02%	10.80%	13.31%	6.10%	9.80%	29.88%	15.24%	25.00%
<b>S&amp;P/TSX</b>	-18.22%	-13.32%	-14.40%	4.72%	12.04%	9.71%	9.83%	17.26%	24.13%	14.48%	26.72%

**TETREM'S US EQUITY MANDATES**

	Annualized Returns to September 30, 2008						Calendar Year Returns				
	Q3 2008	YTD	1 year	3 year	5 year	10 year	2007	2006	2005	2004	2003
<b>Tetrem US Equity</b>	-13.03%	-20.81%	-22.61%	2.10%	9.01%	12.53%	8.32%	19.04%	15.22%	15.92%	23.17%
<b>Tetrem US Equity Plus</b>	-16.20%	-20.99%	-22.84%	3.24%	11.06%	11.96%	11.49%	19.17%	22.64%	15.17%	30.51%
<b>S&amp;P 500</b>	-8.37%	-19.29%	-21.98%	0.22%	5.17%	3.06%	5.49%	15.79%	4.91%	10.88%	28.68%

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 September 30, 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 September 30, 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 sole 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 September 30, 2008 are prepared and presented in compliance with GIPS.

From June 1, 2004 to September 30, 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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