

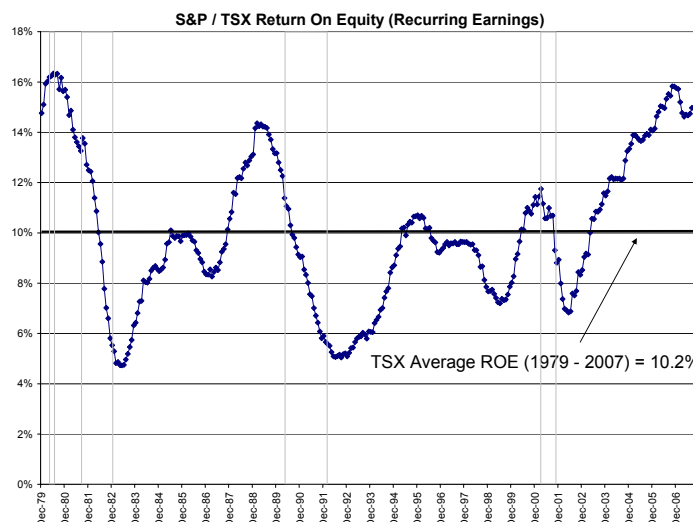
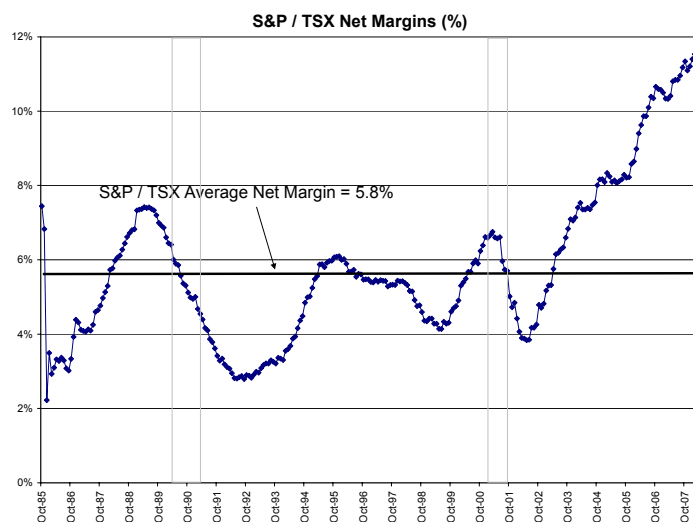
Sionna Insight

Suspension of disbelief

In comic books, villains always lose, heroes always win, Superman can fly, and Spiderman effortlessly scales walls. It is all achieved because readers set aside rational beliefs to accept the incredible or fantasy as fact. It is a phenomenon that writers call the *suspension of disbelief*. Of late, net margins and return on equity (ROE) have soared, flying, like Superman, to all new record levels. Basing stock valuations on these inflated metrics requires a suspension of disbelief about cyclical and secular forces in corporate profitability. Current levels will ultimately prove unsustainable and mean reversion will drag ROEs lower. Simply put, reversion to the mean suggests that over the long-term a data series (P/E ratios, interest rates, economic growth, margins, etc) will always migrate back towards their long-term average. In the past, the timing of ROEs' mean reversion has coincided with overall economic cyclicality. Today's economic uncertainty may prove to be the proverbial straw on the camel's back that results in a secular change in earnings. With history as a guide, a return to "normal" ROEs may prove to be a very painful experience. While almost all industries have experienced above average levels of profitability, trends in the Canadian banking industry suggest that previous above-average ROEs are likely soon to be industry lore.

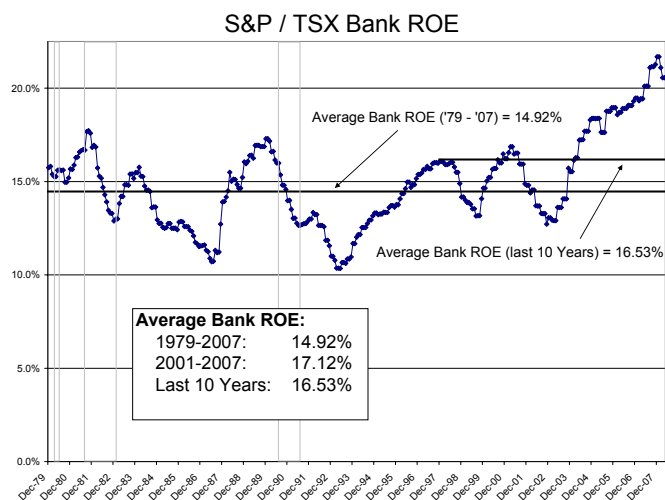
Since 1979, there has never been a sustained period where corporate profitability and ROEs were maintained at today's record levels. In fact, from current lofty levels it is more probable that net margins will drop to below trend levels. From 1985, the S&P/TSX net margin has averaged 5.8%. The last number of years has produced an astounding increase in corporate profitability and net margins. Since the 2001 trough, corporate net margins have increased from approximately 4% to over 11%. Recent net margins are almost two times the historical long-term average. There is no evidence that the Canadian business model has undergone a structural change that justifies the belief that profits will remain sustained at these levels.

ROE has experienced a similar rise of late. As outlined in the chart, based on recurring earnings, the long-term average return-on-equity (ROE) for the S&P / TSX is 10.2%. Driven by stronger levels of profitability, ROE has averaged 13.7% in the last five years, peaking at current levels of approximately 15.0%. Shaded areas represent recessionary periods of economic



contraction. Historically, every such period has resulted in a decline in reported ROE. In fact, when driven by an economic contraction, ROEs on average fall 7 percentage points from peak levels.

One specific example of a sector that exemplifies this trend is the Canadian banking industry. The Canadian banking industry is unique. A well disciplined oligopoly, Canadian banks have consistently generated ROEs in excess of the overall market average. As outlined on the following chart, bank ROEs have averaged 14.92% since 1979. For the last ten years, bank ROEs have expanded, averaging 16.53%, with the last five years averaging 17.12%. Profit margins and ROEs over the last five years have been propelled by several unlikely-to-be-repeated tailwinds. First, investment banking-related earnings were supported by the biggest private equity driven market in the history of mankind. Second, the era of securitization provided ample opportunities to generate strong returns with supposedly no risk and with little effect on bank balance sheets. Finally, loan loss provisioning dropped to record lows. Arguably, we could be entering a period of time when bank ROE trend to below average (past economic slowdowns have all resulted in below average levels of profitability). In an environment of slower economic growth, rising loan loss provisions, and lower investment banking fees, it is difficult to envision a scenario where bank ROEs do not drop from their current record levels. In valuing Canadian bank investment opportunities, Sionna is assuming that earnings power will revert towards historical long-term averages. In contrast, consensus analyst estimates reflect 2008 and 2009 ROEs of 21.6% and 20.7%, respectively. Historically, bank ROEs have bottomed at much lower levels. It should be noted that the average of the five trough ROEs reported by Canadian banks is 11.6%, almost half of current analyst expectations. If history is repeated, bank ROEs at these trough levels will even make Sionna's conservative estimates seem overly enthusiastic.



As we have said many times, our best prediction at any point in time is what has tended to happen in the past. In valuing businesses, Sionna's intrinsic value model utilizes ten-year average ROE as a key input for determining normalized earnings power. Typically, a ten-year period will capture enough history to be representative of a corporation's earnings power over a cycle. Today's market is grappling with the potential of a softening economy. Economic cyclicalities will ebb and flow but a reversion to the mean of historical ROEs is of greater concern. In the past, every economic slowdown has resulted in a period of time where ROEs decline from above-average to below-average levels. To discern value in today's market, Sionna is conscious of the reality that profitability levels of the last five years are unlikely to be sustained. Only in comic books can Superman fly or ROEs remain at today's lofty levels forever!

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 June 30, 2008