

This bear market in my opinion is more about a valuation correction from mania excesses than about the economy or company earnings. The P/E multiple on the TSX is still over 20 and depending on the source the P/E multiple for the S&P 500 is in the 30's or 40's.

The mania and now the bear market has been two tiered and I expect that it will continue. The excess was centered in Technology, Media and Telecom, most of the pain so far has been suffered in these sectors and I expect most of any further pain will be felt in these sectors.

The TSX is now down over 44 % (46% July 23<sup>rd</sup>) and the S&P 500 is down 45 % (47.8% July 23<sup>rd</sup>) from their 2000 peak levels. The decline in the US is the second deepest we have seen dating back to 1875, exceeded only by the 1929 crash which declined 84.8% from its peak. This decline in the US is now 28 months old and is the fourth longest since 1875, exceeded by 33 months in 29-32, 38 months in 46-49 and 43 months in 1881-1885.

Although the TSX is now below the low level we experienced in the after math of Sept 11, we are not seeing as much value available. Last September our model was showing us 130 stocks with expected returns of 30% or greater, which we identified as the fifth best buying opportunity of our career dating back to 1983. As of the close Tuesday, our model was showing 54 names with expected returns of 30% or greater. That's a reasonable level of choice, but given the dramatic market action, rather less than we could have hoped for. Thus, there are some bargains to pick over, but we do not yet see widespread value, which is what one would expect at the bottom of a major bear market. As a value investor we believe in reversion to the mean and mean would be a P/E multiple in the mid-teens. Throw in human excess and it is possible to imagine an overshoot below the mean. After a similar sized decline in 1974, P/E multiples were 7. (I am seeking confirmation of this number before I'll take "draft" off this report)

It isn't critical to buy at the bottom to get good subsequent returns. If you invested 6 months before market bottom in every US cycle back to 1875, your subsequent one year return is an average -0.6%, not exciting, but not painful either. If you invested three months before the bottom, your subsequent 1 year return is a very respectable 7.9% on average. (The one year return if invested at market bottom, is 34.5% on average)

I want to remind you of the math of the markets, a 47% decline from the peak, will morph into an 87% rise back to the previous peak.

The "easy money" to be made in a cycle tends to be earned in the early months after the market bottoms. Based on the four most recent bears, 52.7% of the next three years total return was earned in the first 9 months of the cycle. Some of the best one month returns

seen on the TSX were months immediately following the bottom. (Jan 1975 over 15%, August 1982 just under 15%) Thus I would not recommend any attempt at market timing. By the time most of us would be convinced the market has truly bottomed, there will have already been a significant move off the bottom.

Based on the many calls I have had, a lot of investors want to sell their equity holdings. Clearly many clients are more exposed to equities than they are comfortable with and this crisis is teaching them and you that. I believe strongly in the psychological benefits of incremental trading. Making many small trades over time as your confidence builds is much easier than one big psychologically difficult trade. It probably makes sense to set up a modest incremental measured selling program (dollar cost averaging reversed) to get your client back to their comfort zone. It may well satisfy their urge to “do something” and with any luck it will be mostly implemented after stocks have begun to recover again.

We are closer to the bottom, but I do not believe we are at the bottom yet. However, it is not imprudent to commit money incrementally and regularly into the market now. In the long run you will be rewarded. But it will take courage and stamina.

We believe our funds with below average value multiples and above average yield should continue to relatively outperform the TSX in these challenging markets.

Regards,

Kim

