

103 years ago today, a ship pulled into San Francisco's harbour and off stumbled a few bedraggled prospectors from the Yukon, dragging luggage heavy with gold. With the help of the telegraph and newspapers, the gold rush developed rapidly. When the next ship docked at Seattle two days later, five thousand people lined the dock. People were quitting their jobs and seeking passage on the next ship to find the treasure that "anyone could dig out of the ground". Even the Mayor of Seattle, who was attending a convention in San Francisco, got caught up in the euphoria and wired his resignation as he caught the first ship to the Yukon. By the time the gold rush was over eighteen months later, one hundred thousand "stampedeers" had actually set off for the Yukon. They were naive, inexperienced and ill-prepared, and had abandoned all reason to find their fortune. In the end, there was tremendous hardship, little gold, and the main beneficiaries were those who sold pickaxes and shovels.

The Klondike gold rush demonstrates our humanity, our willingness to believe that an easy fortune can be made if we only do "x". History abounds with examples such as the Tulip Bulb Mania, the South Sea Bubble and many other episodes. As a result, we at Merrill Lynch Investment Managers Canada, believe that pricing in any market is a reflection of human nature as well as of underlying fundamental value. Human beings have always had a tendency to excess, especially in crowds. Excessive optimism and excessive pessimism will move pricing well above and well below long term true net worth. These extremes can create opportunity for rational investors.

I argue that today we are at a period of extreme optimism for TMT.

Do you recall the 1980's, when Japan seemed to have the secret formula for business success and had lessons to offer to the fallen US, which had a weak financial system, a rusting steel belt and an out-of-touch auto industry. Then its bubble burst and now the flexibility and strength of the US business model seemingly has a lot to teach a fallen Japan.

Remember when Gold was \$425 an oz in 1993/4 and the subindex rose over 100% in a year and grew to 12% of the TSE300. The hottest IPO's were small exploration companies in far off emerging economies. Later the Bre-X scandal broke and the Gold and Precious Metals subindex now represents only 2.3% of the TSE300 index. Today it is virtually impossible to raise equity capital for mining exploration.

Enthusiasms ebb and flow and prices ebb and flow and so it will be for technology and Internet stocks ... some day.

Value managers like to take advantage of this basic human foible, and seek to buy good stocks trading well below their long term net worth or intrinsic value, and sell or avoid those stocks trading well above their intrinsic value. They then patiently wait for prices to "revert back to their mean" over time. Academic studies have verified the effectiveness of this

method over the long term. Value investing is not practised as widely as one would expect, largely due to the folly of man. The Value management style has a tendency to underperform in hot, frothy markets and thus it requires more patience and perseverance than most participants can withstand (the current market environment is a good example).

Let us tell you a tale of two solitudes. Let's compare two recent acquisitions: UBS's bid for Paine Webber versus JDS Uniphase's bid for SDL.

	Paine Webber	SDL
Bid	\$10.8 billion	\$41 billion
Net Profit	\$606 million	\$25 million
ROE	22.6%	9.8%
P/E	17.8 times	1640 times
P/BV	3.7 times	98 times
PSR	1.4 times	219 times
Currency	stock and cash	stock

Paine Webber is the 4th largest US Broker with 120 years of history, 8,500 brokers and 2.7 million clients. UBS wants to build a global financial presence with this acquisition. The offer was a 47% premium over the listed stock price. The market worried that the price was rather high and the fact that few mergers are successful. UBS's stock fell on the news. This deal is "expensive" in the traditional sense of valuation.

JDS is the largest maker of fiber optic products, the hottest area of the telecommunications market currently. JDS has yet to earn a profit and has a P/E multiple of 260 times earnings before goodwill and amortization. Undaunted by the challenges of their recently completed merger of \$20 billion with E-TEK Dynamics, JDS announced and agreed to pay obscene multiples for SDL with "funny-money"/its own hugely inflated stock. The market liked the deal and took the price of JDS up. Who is more at risk? Management with vested, restricted and optioned stock or investors who are paying real cash at 260 times earnings? This deal is "reasonable" in the new era sense of valuation.

We are making new financial history. We have never had major stock markets trade at such high multiples before. This may be a new era, but it appears that the pricing has gone too far ahead of the fundamentals. Backing out the implied growth rates behind a number of highly priced stocks indicates assumed growth rates of 30-50 % for 10-15 years in order to justify current pricing. Sandford Bernstein recently published a study indicating that no large cap company had ever compounded earnings in excess of 25% a year for 10 years.

Our market is hitting all new record highs off the back of a smaller and smaller group of hot technology stocks. Meanwhile, many stocks are languishing at great values and the market remains disinterested. Auto suppliers, retailers, real estate, banks, mines and minerals, forest products, steels, chemicals, fertilizers, electrical utilities and pipelines all represent good value. We haven't seen so many solid citizens of corporate Canada with solid earnings and earnings growth trading at cheap prices and still languishing on the bargain basement shelf.

The following is only a selection of stocks that are trading at 10 times or less, this years earnings: Alcan, Bank of Montreal, Bank of Nova Scotia, CN Rail, Canadian National Resources, Canadian Tire, CIBC, CP, Dofasco, Falconbridge, Fletcher Challenge, Hudson Bay, Inco, Magna, Trilon. These stocks are trading at 10 times the stock price or less, when the market overall is trading at 30 times earnings. These stocks are all trading significantly below their Intrinsic Values. These companies' earnings are not at risk, most are expected to see their earnings rise at least 10 % per annum. These stocks all represent a low risk opportunity to make a good return over the next few years as prices revert back to their long term historical averages. And you have the opportunity to buy these now while the market group-think is focussed on the latest adrenalin stocks.... fiber optics.

Nortel is trading at 110 times current earnings, JDS is trading at 176 times earnings, RIM isn't expected to have any earnings this year, but if we use next year's projected earnings, it is priced at 713 times earnings. Investors clearly believe that earnings in these companies are going to grow and a lot! A lot more than we have ever commonly seen in financial history, for a lot of stocks!

So I now want to know what is wrong with a low risk 15% return 2/3rds into the year? Our performance attribution guy has pointed out to me that our style of investing carries no more risk than a bond fund, but we enjoy equity returns. (The average Canadian Bond fund would have earned less than 4% YTD.) The TSE historically has earned investors 9% per annum, so 15% is well above average. Value managers like ourselves are being treated like Maytag repairpeople. Investors are clamouring for the fashionable tech, media and telecom funds and ignoring what may well prove to be the real investment opportunity. The Technology and Media mania has been running the markets for the last year and change, the prices are very high and the risks are high.

Our rational, low risk approach has blinded us from following the pied piper of technology riches. We've out-performed or matched the market using this style 9 out of 10 years. We tend to under-perform in hot, frothy and speculative markets. (We've under-performed last year and so far this year.) We have demonstrated an ability to perform very well when the market is flat or declining, (March, April and May of this year were an excellent example of our fund's resiliency, when the tech stocks stumbled) and our low risk style doesn't mean we can't hit home runs, we've out-performed the market by 10% in 1991 and again in 1997! We have a proven ability to be the fund you can sleep well with at night. We are the fund that you can feel comfortable about owning, when you hear that the market has just experienced a sickening slide.

We build our portfolios to perform and protect, and we know there are a lot of rational investors out there who want just that.

Horace wrote "Many shall be restored that are now fallen and many shall fall that are now in honour". At some point, common sense will return to the market and the tide will turn. Eye popping multiples that are setting new financial market records will "revert" down to more normal levels.

History has shown us that the best time to sell new-era stocks, is not at the point of maximum implementation of a technology, but at the point when people are most excited about it. (reference railways, electricity and auto stocks)

We at MLIM have built up a long experience of investing. We have earned our MBA's and CFA's and earned our stripes by investing in up and down markets. We know that clients of Merrill Lynch are turning to us to help them achieve their long term investment goals and dreams. We have no desire of squandering that trust by chasing the latest fashionable investment folly. Rational investors want consistent low risk returns, they recognize that a 15% return 2/3rds the way into a year is preferable to potentially fleeting high risk returns. And we want to offer investors that choice.

Value investing has served investors well over the long term. It tends to perform poorly in hot, frothy markets and it has tended to make up for that deficiency in the long-run. Our rational, low risk approach has blinded us from following the pied piper of technology riches. We know at some point this current speculative frenzy will end badly. We haven't followed the risky path, and have earned our clients above average returns with very low risk.

The ML CDN Core Value Fund is a good CORE capital preservation fund around which more aggressive/risky plays can be counterbalanced. I hope you agree. I welcome any questions.

Regards,

Kim