

Value Thoughts to Ponder in an Emerging Global Credit Crunch **November 19, 2007**

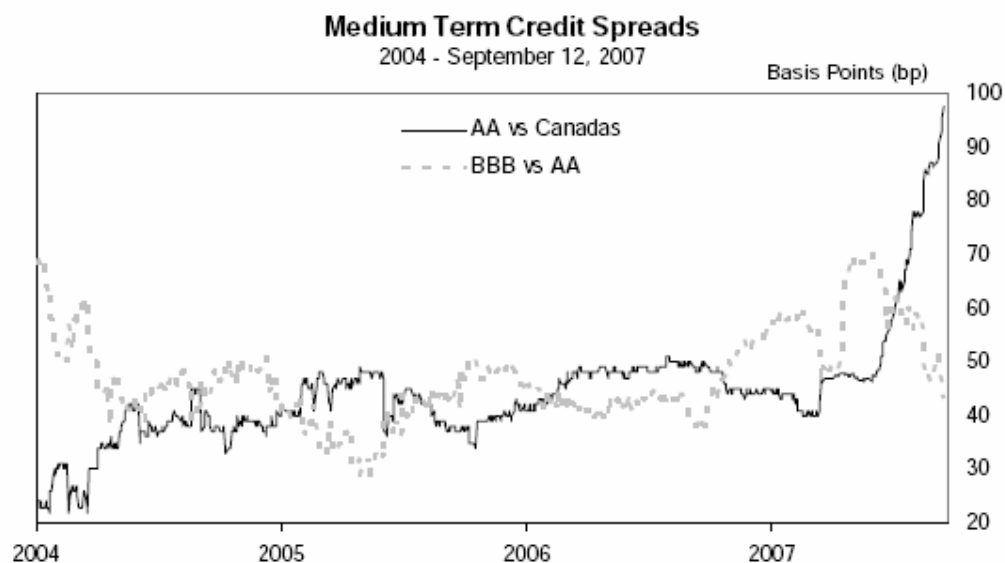
The Canadian banking system is relatively unique. We have a virtual oligopoly with five large, well capitalized, extraordinarily profitable banks that have fended off all global players on their home turf. In the last several years Canadian bank valuations relative to global banks have risen, and deservedly so due to the strong growth of Canadian banks and the significant barriers to entry into the industry. Also, the Canadian consumer has a relatively low level of debt to disposable income, and certainly relative to the US consumer, Canada has a strong economy, a fiscally prudent government and a strong dollar - all good news for the financial services sector. Until recently Sionna was confident that the Canadian banks would sail through any US related sub-prime real estate problems and would maintain their strong valuations, while providing a great high yielding way of hunkering down in the Canadian market. Sionna now suspects that the return on equity (ROE's) of Canadian Banks will decline from the record highs of just over 20% (as a group), that dividends won't increase as quickly as previously thought and that share repurchasing may grind to a halt. Our concern is that this will weaken investor confidence enough to make the banks valuations more vulnerable to any widening global credit crunch.

Today's market dynamics warrant a defensive posturing. We have always found it psychologically easier to be early and proactive before the market confirms a change in focus. It is always much harder to lag a turn in the market and try to trade after the view is widely held. Even in the tech mania blow off in 2000, there was plenty of time to change an investment position with more than adequate warning.

Sionna's view changed over the summer as we all learned about the (non-bank sponsored) Asset Backed Commercial Paper (ABCP) market that most of us were probably unaware existed until the market seized up in August. The problem emerged when some ABCP investors became concerned and declined to roll over their investments. Seeking a solution, a group of investors formed the Montreal Accord, which essentially froze the entire market consisting of face value of some \$35-40 billion (which apparently can grow in size due to the leverage embedded). The group then engaged the eminent "fixer", Purdy Crawford, to sort out the problem and negotiate an acceptable solution to the participants. At first, Accord members hoped a mere extension of term into a new instrument would create the fix. Although some ABCP is probably plain vanilla, other paper is complex, which makes unwinding the instruments to the satisfaction of all the various diverse interests involved virtually impossible. If it all works out well, the ABCP holders will likely take a 10%-60% loss depending on the level of risk of the particular investment vehicle. The fear is that the losses could be the larger sum and that lawsuits could be numerous and spray widely. This could be painful

for those involved, but not likely enough to cause problems to the financial system at large.

Meanwhile, the Canadian banks themselves have their own bank sponsored asset backed commercial paper market, which is believed to be approximately \$80 billion in size. This market largely consists of baskets of mortgages, car loans and credit card balances that they have been “securitized” or packaged into bundles and sold off to investors. Investors have now become skittish about where their cash is (witness the high levels of money market redemptions in August) and Treasury Bills have suddenly become fashionable. Rumour has it that as the bank commercial paper matures, there is not enough buyers for the rolls, and thus the banks have been active purchasers of their own paper (comparative evidence suggests up to a quarter of issues are likely being absorbed by the banks). As a result, banks are using their cash and capital suddenly on an “investment”. Banks have also been issuing three and five year notes and preferred shares to raise Tier One capital in response and the banks have had to pay up to raise the money-spreads have widened out to about 90 basis points above Canada bonds as depicted in the following chart.



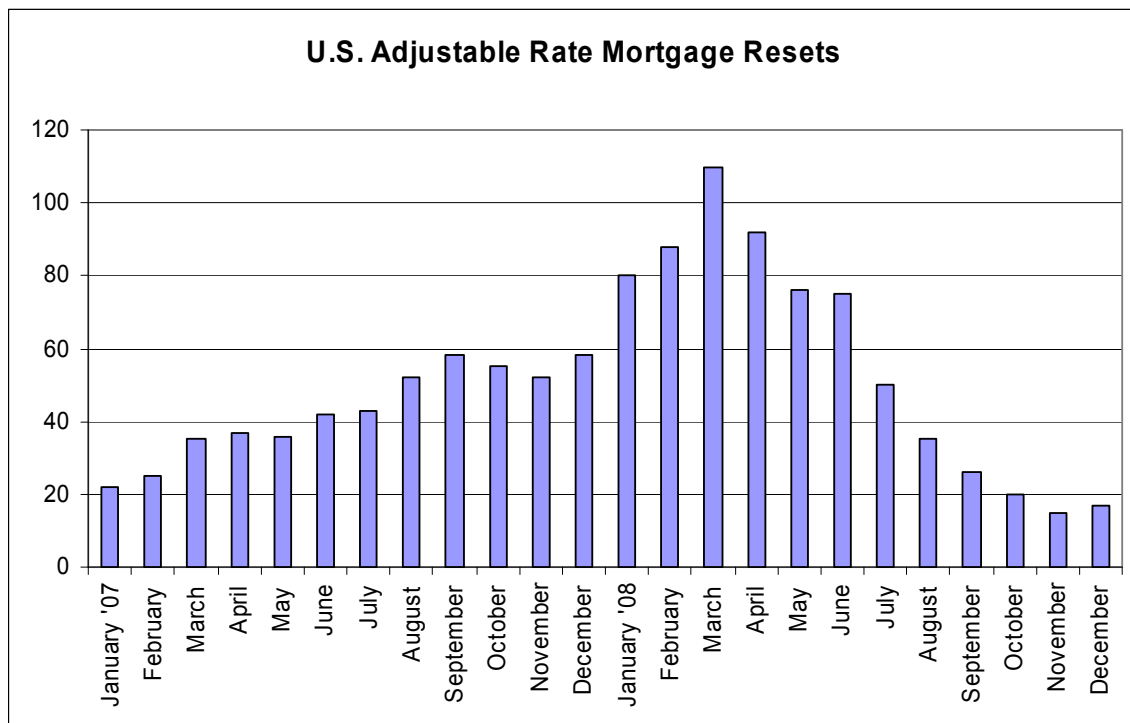
Source: PC-Bond Analytics.

Sionna has always believed that markets are moved as much by human excess as by true fundamentals. Credit growth in the last several years has been extraordinary, and the excess is highlighted by the well known US sub-prime real estate problems where mortgages were issued to questionable earners with low deposits and low collateral. Sionna is also concerned about leveraged buyout loans (LBO's), both plain vanilla and “squared” Collateralized Debt Obligations (CDO's) derivatives, Structured Investment Vehicles (SIV's), exposure to hedge fund lending and credit default swaps. The Canadian banks are variously exposed to some or all of these to greater and lesser degrees. Some of

these are inter-related: for example, problems in sub-prime mortgages affect the CDO's and SIV's in which they are embedded, which in turn will put pressure on the "insurers" behind the credit default swaps that are backing the products. The leverage embedded in a number of these products has contributed to the rapid magnification of losses and write-downs.

Problems in any of these areas may lead to a continuation of rising defaults and write-downs. Canadian banks may weaken and become more vulnerable to other problems that may emerge over the next year.

Sub-prime resets (mortgages that were initially sold with low "teaser" rates, after a set period of time then rise to market levels, leading in some cases to significantly higher monthly payments) will remain high until March 2008, and then defaults will set in a few months later as it takes time for borrowers to finally throw in the towel. We suspect that the magnitude of global credit problems will be better known by June 2008. We believe it is prudent and cautious to modestly underweight financial services and banks until the full magnitude of the challenge is better understood.



We started this report in August, but the lack of concrete evidence to quantifiably and reliably measure and prove our concerns prevented us from committing our thoughts to the printed word and disseminating it to our clients. New fast growth areas take some time before they are captured by Generally Acceptable Accounting Standards (GAAP) and disclosure is idiosyncratic and not easily comparable. We found in-depth conversations with credit derivatives specialists nearly incomprehensible, leaving our entire team (which holds six CFA's, an MBA, and combined industry experience of 60

years) wondering whether senior financial services management and the boards of financial services companies could truly comprehend the situation as well. We continue to gather and examine emerging evidence on the credit front, but suspect that definitive evidence on the magnitude of the credit problem will emerge after the fact and not before.

We have been concerned since August. All news so far has served to convince us that the problem is real and growing. Merrill, UBS, Bank of America and Citibank have recently found themselves needing to revise the potential losses to significantly larger sums.

Sionna believes that its value proposition with clients is to be defensive and protective of client's principal, especially in weak or declining markets. Although we fundamentally still believe that the Canadian banks and other Canadian financial services companies are best positioned to withstand this global credit storm compared to their foreign peers, stormy times are still ahead.

“Money has often been a cause of the delusion of multitudes. Sober nations have all at once become desperate gamblers and risked almost their existence on the turn of a piece of paper. Men think in herds; it will be seen that they go mad in herds, *while they only recover their senses slowly, and one by one.*” Extraordinary Popular Delusions, Charles Mackay 1841 (italics added)