The VIEW from BURGUNDY

MAY 2001

A Year of Living Dangerously

Richard Rooney, CA, CFA, President of Burgundy, gave the following speech at Burgundy's Client Day on May 8, 2001.

A Year of Living Dangerously

When you saw the title of my presentation today, I expect you thought we were going to review last year's peculiar markets. That would have given us the opportunity to indulge in false humility or blatant self-congratulation, thus confirming all your worst suspicions about money managers. But the title doesn't refer to last year. It refers to this one.

A review of last year would have been quite amusing, since there was an unusual degree of human folly on display, even by the exacting standards of Wall Street and Bay Street. But, as my mother would say, that would "butter no parsnips." A year ago, improved returns for Burgundy were inevitable – our stocks were compelling value and most others were not. In that situation, all a value manager must do is await the correction and hope that he or she still has some clients left when it occurs. Fortunately for us, we have patient clients.

Last year, what you wanted was assurance that we had a technology strategy and were not just indulging in willful ignorance. What do you want to know this year? If I were you, I'd have three questions. First, as we look to the future, what are we worried about? Second, which worries are likely to be valid ones? Third, how do we prudently seek good returns in the light of these concerns?

Addressing the future is always a hazardous undertaking. Dan Quisenberry, the hard-throwing right-hander for the Kansas City Royals in the 1980s, was once asked about the future. After a brief pause for thought, Dan said that he thought the future would be much like the present, only longer. With such a grasp of the essentials of financial forecasting, Dan could have had a second career on Wall Street. But he illustrates an important point – it is difficult to uncouple yourself from your present and recent past, and see your situation in historical context. I am going to try to do that today.

Our worries fall into three categories. First is the economy. I'm going to spend a few minutes on top-down economics, even though we usually don't do that. Second is a related matter – the impact of a very weak or very strong economy on our relative performance. The last worry is about valuation and growth expectations in the equity markets. My goal is to assess these concerns, select the valid ones and devise a prudent strategy to protect our clients' capital.

Let's turn to top-down economics.

I've prepared four slides that each show a perfectly plausible conception of where the world could go over the next five years. Chart No. 1 is entitled Apocalypse Now. In this world, North America goes into deep

CHART #1 – APOCALYPSE NOW

Probability – 10%

- North America goes into deep recession
- Japan deteriorates further
- China goes into crisis
- Worldwide economic slump worst since World War II

Five-Year Expected Returns

Bonds	9.0%
Equities	(10.0)%

recession as the consumer pulls in his belt and, at long last, saves some money. Japan remains mired in difficulties, China's economy stalls and the world economy declines for the first time since World War II. This world is brutal for equities and good for bonds, as you see.

Chart No. 2 is named after Doctor Pangloss, the idealistic professor from Voltaire's *Candide* who had an unshakeable conviction that "everything is for the best in this best of all possible worlds." † In this world, the U.S. economy doesn't miss a beat, and continues to grow. Japan begins to recover, and Europe becomes a modest engine of growth. This world is great for equities and not so good for bonds.

CHART #2 – DR. PANGLOSS

Probability – 10%

- North America continues slow growth
- Japan and Asia recover
- European growth accelerates

Five-Year Expected Returns

Bonds	3.0%
Equities	12.0%

Chart No. 3 is called Hard Landing. North America falls into a sharp recession and drags down world growth rates with it. This is a tough outlook, under which bonds do a little better than coupon and equities are dead money for the next five years.

CHART #3 – HARD LANDING

Probability – 40%

- Sharp recession in North America, slow recovery
- Gradual recovery in Asia
- Slower growth in Europe
- Confidence shaken, remains fragile

Five-Year Expected Returns

Bonds	7.0%
Equities	2.0%

Chart No. 4 is the Soft Landing outlook. A recession in North America is shallow and brief, Asia recovers and Europe continues to grow. Bonds return their coupon, while equities give a reasonable, but below trend rate of return.

CHART #4 – SOFT LANDING

Probability – 40%

- Shallow, brief recession in North America
- Recovery in Asia
- Growth in Europe
- No real crisis of confidence

Five-Year Expected Returns

Bonds	5.0%
Equities	7.0%

As you can see, I weight these outlooks based on probabilities. If you derive the expected values of these outlooks, you will see that the expected returns from both equities and bonds are mid-single digits for the next five years under almost all assumptions.

That's the bad news. The good news is that this is the presentation, almost word for word, that I gave to a client who specifically asked for a top-down review in November of 1998. I plan to continue to give this presentation at 30-month intervals until one of the forecasts comes true. It is pretty remarkable how well the presentation has aged. But it reflects the danger of top-down thinking for people like us. It doesn't look like you should take economic concerns very seriously when your money manager enunciates them; even if we are right about the economy, we are unlikely to understand how financial assets will react to a given economic outcome.

It is perhaps tough to recapture how scary the world looked in the fall of 1998. Russia had defaulted on its debt and non-sovereign bond markets collapsed. Long-Term Capital Management, a huge hedge fund in the U.S., went to the brink of insolvency. Everywhere there seemed to be a deflationary hurricane about to engulf the world. And clearly it affected our thinking. We asked our clients to really go back to the drawing board and decide whether they needed bond exposure in their holdings, and we recommended a holding of 25-35% in fixed income for all accounts where we managed substantially all the clients' wealth, and where there could be a call on the capital within the next five years. That didn't prove to be a bad decision, but a better one would have been to stay in equities.

The actual index returns over the 30 months since our bearish forecast have been consistent with the soft landing outlook – about 5% for bonds and 7% for equities. Burgundy has done a little better, with compound North American equity returns of about 15% over the period. The best investment we offer that you could have made in 1998 was our Japan Fund, which has compounded capital at 25.7% over the 30-month period.

This anecdote shows why bottom-up stock pickers shouldn't get caught up in big picture economic concerns. We should beware of top-down optimism or pessimism and concentrate on understanding the outlook for our companies. It never hurts to re-examine your investment guidelines and to be sure that you really are a long-term investor, but by and large, equities are the place to be if you want to build your wealth. The only question is, which equities?

As all of you know, we tend to invest in a fairly narrow range of industries, such as newspapers and media, consumer staples, financial services, and selected, less cyclical industrials and retailers. They are generally less sensitive to the economic cycle than some other industry groups, and show steady growth in most circumstances. In contrast, some other groups benefit disproportionately from very strong or very weak economies. For example, the technology boom of 1999-2000 was partially touched off by the great strength of the economy in those years. Technology has to some extent replaced bricks and mortar as the thing companies spend their money on late in the economic cycle. If the economy is very strong in the next few years, the tech boom could re-ignite. But I think a return to the crazy days of 1999 is unlikely anytime soon. The valuations are still not sensible, growth expectations are too high and the fundamentals are poor.

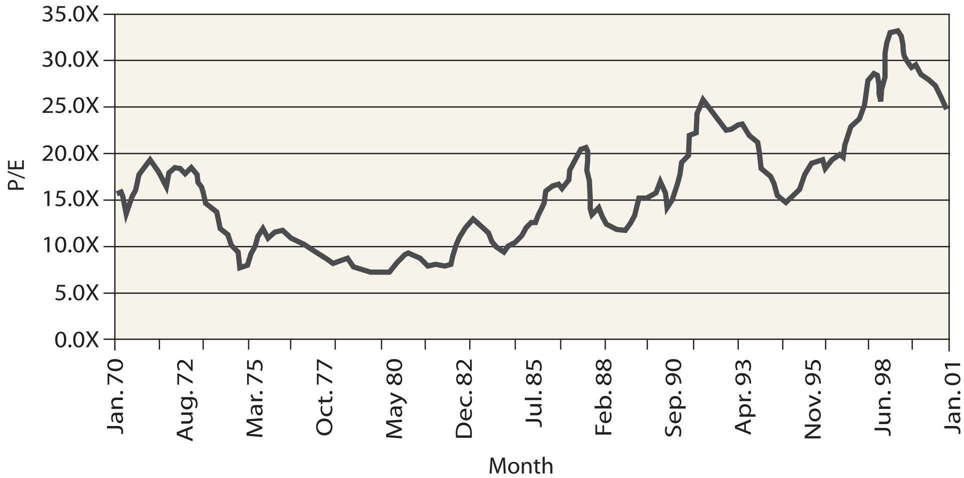
Another potential area that would benefit from a strong economy is that of cyclical stocks, which have had a few false dawns in the 1990s, but have yet to seriously embarrass us. One of the surprises of the past six months has been the strong performance of a lot of deep cyclical stocks. In Canada, we have owned Methanex and Cameco, a couple of cyclicals with good balance sheets and strong market positions. They have been among our big winners over the past year because they were purchased at very cheap levels. Some other cyclicals, like the railways and Alcan, have also been acting well. If they continue to do so, it may be evidence that the powers that be have been able to pull off the elusive economic soft landing. A surprise that we haven't seen in many years would be an old-fashioned, Old Economy commodity blow off. It would mainly affect our portfolios in Canada and, in a long shot, Japan because those markets have substantial cyclical weightings. In those markets, our relative returns could suffer. Remember, we don't invest much in cyclical stocks because they are basically bad businesses.

At the other end of the spectrum, if we go into a recession, the regulated utilities have always done well because of their traditionally low business risk and bond-like investment characteristics. But this area may not behave as it used to because broad-based deregulation of energy and telecoms has led to a much more uncertain environment for these companies. And a wave of acquisitions at extremely high prices has left many industry participants with unusually weak balance sheets. So they can't really fill their traditional role as safe havens.

On balance, we are satisfied with the positioning of our portfolios for the coming year. We own companies for all seasons – businesses that do well in most market environments. You've already seen what that means over the past few years: we tend to lag frothy bull markets, grow steadily in trading markets and outperform down markets, sometimes even growing our value against the trend – as long as the trend isn't too strong. We do best when the market is rewarding the economic characteristics of our businesses, and when the valuations of our companies are low relative to competing investments. In other words, we do well in a year like 2000.

Our portfolios in Canada and the United States have appreciated by 30-40% over the past year. The bad news is that our companies are on average over 30% more expensive than they were last year at this time. Value managers try to cultivate a rather peculiar state of mind where our spirits rise as stock prices fall. The contrary is also the case – as prices rise, we should become more and more drawn and haggard. I hope we look sufficiently careworn to convey to you the difficulty of finding value in this market.

S&P – TRAILING P/E
1970 - 2001



Source: TD Securities

What About Valuation?

Let's look at how the whole equity market is positioned in 2001. The overview is not reassuring.

The chart above shows what has been paid for a dollar of earnings of large cap U.S. equities over the past 30 years. Earnings multiples have come down somewhat from the scary levels of last year. But they are still above long-term averages.

What About Our Stocks?

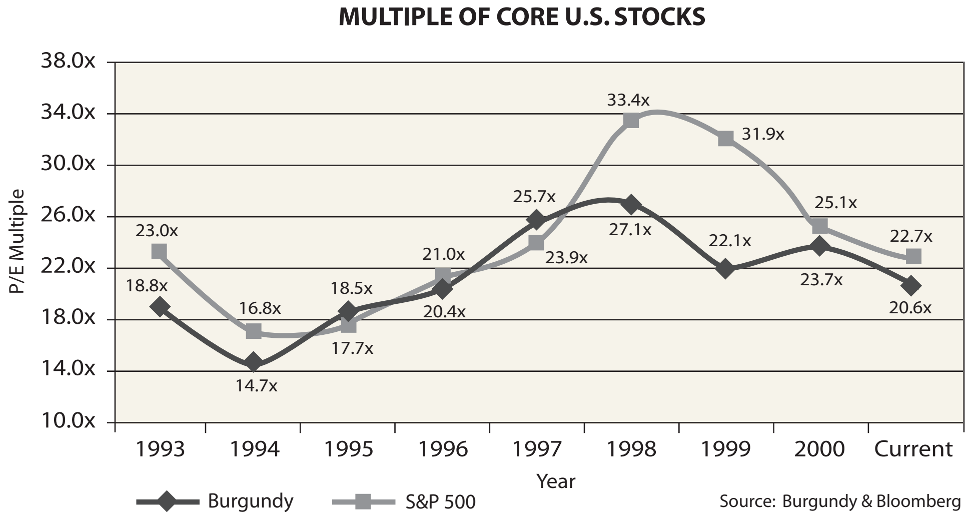
Our stocks are generally trading at about the earnings multiples that they reached in 1996. But the economy in 1996 was strong, unlike today's economy. And in 1996, a huge proportion of the participants in the capital markets had not yet been exposed as frauds and incompetents. That happened in 2000, with the collapse of the bubble.

High valuations should correlate to high confidence in the system. After last year, I believe that almost all participants in the capital markets are to some extent discredited.

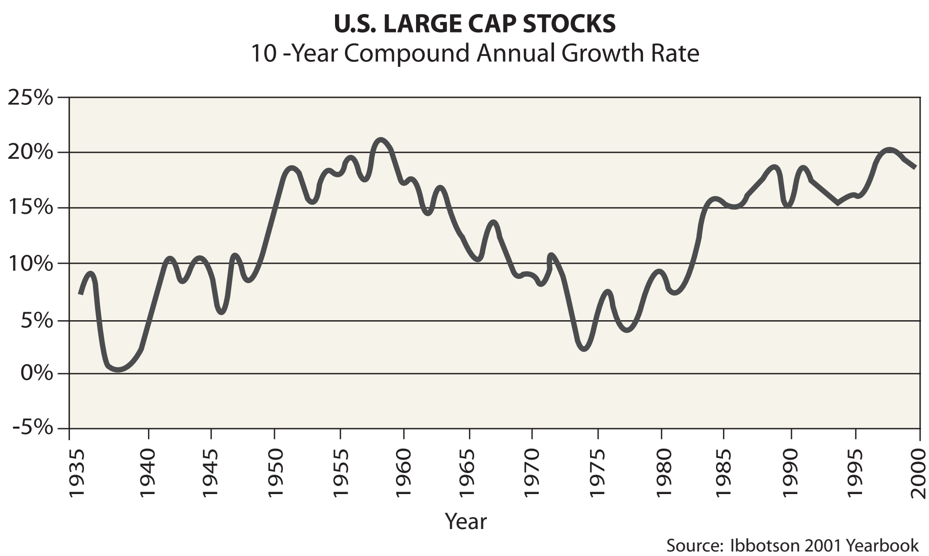
High valuations at a time when the system deserves no confidence make a dangerous combination.

I could show you many charts, all illustrating that in terms of dividend yield or book value or just about any other measurement, the current equity markets in the U.S. and Canada are extended. I could also show you that, relative to those markets, our portfolios are less expensive. But I hope you know that anyway. Let me relate the value problem to you in another way – by thinking about the fundamentals of our companies.

The problem we have whenever we look at our companies is trying to identify sources of long-term volume and revenue growth. That is getting tougher



and tougher. The game of reducing costs to increase earnings has pretty much been played out, and a lot of our companies are now in the mode of investing heavily and often belatedly in their businesses to try to grow the top line. That can't be good for corporate profitability either in the short or the medium term. Warren Buffett, in his latest annual report for Berkshire Hathaway, said the stock market outlook for many of his companies was unexciting. We would have to concur about most of our large cap investments. They are not scary, but they are unlikely to deliver the kind of returns they did in the last decade. Single-digit returns are probably the fate of most investors over the next 10 years – Buffett at his annual meeting said 10 to 15 years.



I thought it would be interesting to look at what the distribution of longer-term returns has been. The next chart shows the sequence of all 10-year period returns since 1936 – that is to say, the first point is 1926 to 1936, the second 1927 to 1937, and so on. There is clearly a pattern here. Periods of very high returns are succeeded by long declines as valuations are corrected. This data is probably not meaningful because there are far too few observations to use as a predictor. But the chart would appear to show that – to misquote Shakespeare – there is a tide in the affairs of the stock market, which taken at the ebb, leads on to fortune. In North America, we're at the flood, not the ebb.

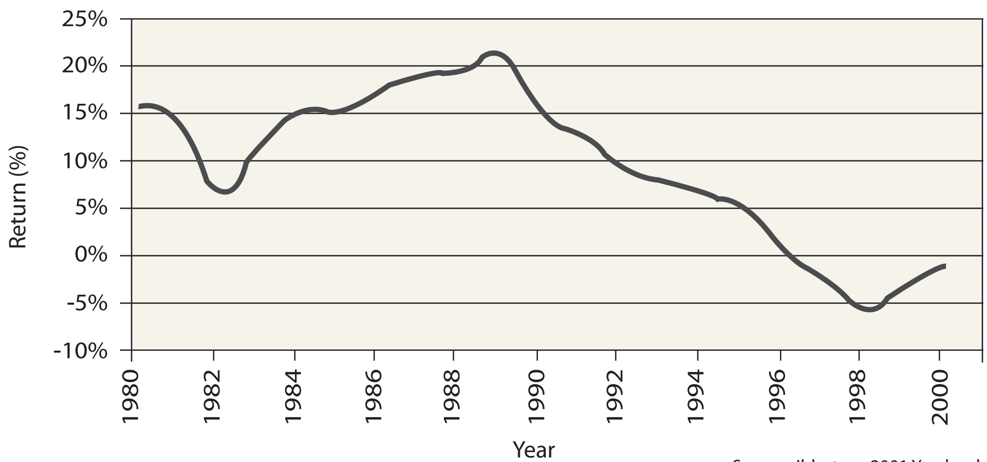
I believe that these last concerns are the valid ones – that value is tough to find in North American markets and that those markets are overdue to disappoint.

So what can we do? Would we recommend that all our clients go into lower-risk but also lower-return asset classes like treasury bills and bonds? No. When all is said and done, equities are the way to build long-term wealth. But we think there is a better way to go. Much as we love the U.S. equity markets, with their liquidity, good governance, and splendid listed companies, there are other opportunities in this world.

Look at this chart of 10-year return sequences for Japanese equities.

JAPANESE TOPIX

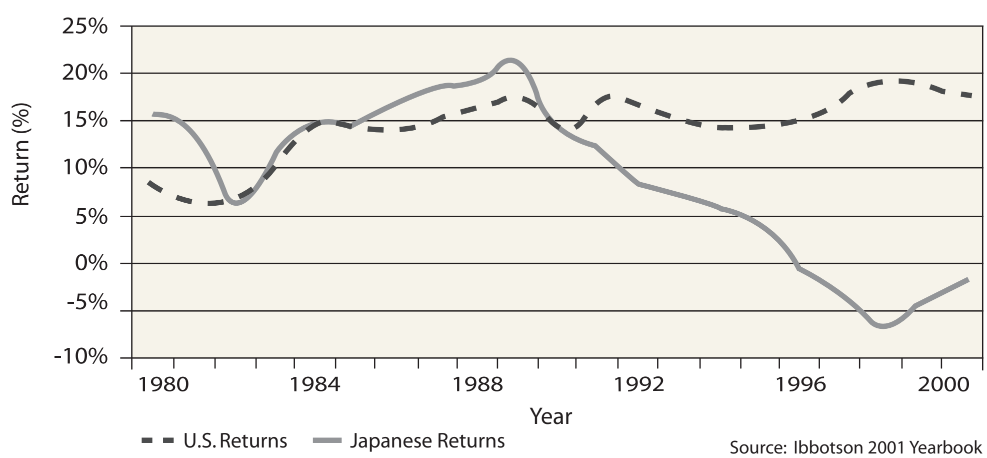
10-Year Compound Annual Growth Rate



Source: Ibbotson 2001 Yearbook

I think we can say that, despite the smaller number of observations, there is a very different pattern apparent here. If you want the basis of our strategy for involvement in Japan, take this chart and add a compelling value story. Just to emphasize the point, let's look at the U.S. and Japan together over the same period. I know where I'd rather be.

U.S. AND JAPANESE 10-YEAR COMPOUND RETURNS



Source: Ibbotson 2001 Yearbook

So where do we go from here?

The byword for the coming year should be caution. If you are a pure equity investor, you should diversify beyond North American markets and look at our Japanese and European Funds. If the news on Japan appears to be terrible, remember that a year ago, the news on technology stocks was uniformly glowing. Being contrarian usually only looks smart in retrospect – at the time it can, and should, look downright scary. The emergence of an equity culture in Europe is also an exciting development. So the Europe and Japan funds should give you the opportunity to achieve low-risk incremental returns.

If Burgundy manages a very substantial portion of your wealth, and if your time horizon is less than five years, you should place a portion of your money in bonds and treasury bills. If you are satisfied with your current positioning, you should, in any case, be expecting returns from the next five years that are substantially below those of the last five years. For our part, we will develop new products to help in the process of diversification.

It seems likely that we will all get rich slower in the next 10 years than in the last 20. But barring an incursion of the Four Horsemen, I think we will be richer. Our main goal should be to protect ourselves prudently through intelligent diversification. I have mentioned investing in European and Japanese equities as good ways to pursue that goal. It is also a good time for all our clients to sit down and seriously assess their investment objectives and positioning. If you've been aggressive relative to your real situation over the past few years, protect yourself either through diversification into new equity products or through fixed-income positions. Market timing is a mug's game, but correct positioning relative to your needs and risk preferences is essential.

It is entirely possible that when we meet again, my advice will have proved to be wrong, and North American equity markets will have continued to push skyward. That is the problem whenever you say anything definite about investing. That is why so few people ever do say anything definite about investing. And after all, we were wrong about the future in 1998. But people who have been riding the single wave of North American equity markets are living dangerously, and we feel that the time for living dangerously has passed. It will be the prudently diversified investor who prospers in the coming years.

Endnotes

† Voltaire. Candide. Translated by John Butt. New York: Penguin, 1950.

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