

## **OUTLOOK – FOURTH QUARTER 2002**

### **Equity Markets**

The combination of rising geopolitical tensions, a slowing U.S. & global economy, and continued over-valuation in the equity markets has created enormous equity market volatility. Not surprisingly, after the markets have declined by nearly 50%, the typical mutual fund investor is running for the exits. The withdrawal rates from equity mutual funds have been staggering and this creates the vicious cycle where managers sell to fuel redemption, causing equity prices to decline further and thus causing the investor to further redeem his funds.

On a positive note (briefly), the consumer has benefited from tax cuts and declining interest rates. However, this mortgage refinancing boom may be the cause of its' own destruction. Over the past year \$600 Billion have been created in new mortgages. However new house mortgages only account for about \$200 Billion. Thus the consumer has been refinancing their homes, adding on more leverage because of the lower interest rates in order that they can continue with the spending habits developed in the 1990's. This is potentially a recipe for disaster. It is also interesting to note that in the second quarter of 2002, home building executives of public companies sold \$258 million of their own stock, reducing their shareholdings by the largest amount seen in individual records going back 20 years!

Amongst this doom and gloom there is a sense of optimism. The most important is that it pays to be a contrarian. When everyone believes that the market is going nowhere but down and now is the time to get out – it is time to buy. Further, we are now entering the strongest part of the year – the period from mid-October to early spring. We believe that with the market down 28% year-to-date that we will have a nice rebound to finish off the year.

### **Options:**

We have been very active in writing options against all of the Canadian bank stocks in order to lesson the risk of decline which we felt was imminent. This strategy has been very successful. Anticipating a year end rally we have purposely not written many call options on stocks held in your accounts. Writing an option essentially builds a ceiling. We do not wish to limit the potential gains during this anticipated year-end rally and thus have left most positions alone.

**Fixed Income Markets:**

With a declining stock market, investors poured themselves into the bond market driving prices up and lowering rates to 40-year lows. We had sold some of our long bonds at the beginning of the quarter and thus had a lower duration (average term) than the index. For the first quarter in many years our bond portfolio slightly under-performed the benchmark (3.46% vs 3.88%). However we have still handily outperformed over 1 year (8.63% vs 7.93%) and 5 years (6.70% vs. 6.56%). This may not sound like much of an accomplishment other than to note that beating the index is not often done. Mutual fund data to August 31, 2002 shows that over one year the average Canadian bond mortgage returned 5.6% versus 7.9% for the index and over 5 years the average was 4.9% versus 6.9% for the index. Over the 5 year period only 7 of 117 managers beat the index. Thus we are very proud to continue to offer management that puts us in the top 5% of Canadian managers.

**CEO Fund**

The CEO Fund started the quarter at \$10.19 US and ended the quarter at \$10.487, an increase of 2.9%. In Canadian dollars, the CEO Fund started at \$15.57 and ended the quarter at \$16.50, an increase of 6%. During this period, the S&P 500 was down 17.6% expressed in US dollars, or 15.1% expressed in Canadian dollars. For the quarter, the Fund outperformed the index by 20%! Year to date, the CEO Fund has outperformed the index by over 30%!

The market decline this year has been much more severe than what we were expecting. In spite of the fact that the market is down by 30%, the CEO Fund is actually up slightly for the year. Very few funds, with the exception of specialty funds, can match the performance of the CEO Fund.

We continue to expect a rebound for the final quarter of the year, traditionally the strongest quarter of the year. If we get the expected rebound, results for the year are expected to be excellent.