



## FRONT STREET CAPITAL

33 Yonge Street, Suite 600  
Toronto, Ontario M5E 1G4

telephone: (416) 364-1990  
fax: (416) 364-8893  
toll free: 1-800-513-2832

## FRONT STREET PORTFOLIO MANAGER UPDATE

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### **Norm Lamarche: Small Cap Fund, Special Opportunities, Mining Opportunities**

Norm Lamarche wasn't available for comment yesterday, however, I spoke with him this morning (Jan 22). Norm noted that clouds of uncertainty are hanging over the market so don't buy uncertain stocks! With commodity prices remaining high (Copper, Gold, Oil etc) buy companies that are producing, don't bother with companies that are in pre-production stages since the market doesn't care about them right now.

Norm has increased his large cap exposure and has positioned his funds in natural gas stocks. He actually positioned his portfolio's (Small Cap and Special Opportunities) in natural gas names in Q4 2007 and it hurt him, now it is starting to pay off. The reason he took those positions was due to the following:

The Alberta Government asked Norm to provide his opinion/views on the proposed royalty rate changes. Norm felt that the old system was "flexible" and worked for the oil and gas sector. If oil and gas prices moved higher, project opportunities increased in value as did the land that the projects were on. The increase in the value of the projects/land ultimately gave the Government a greater take of the profits.

Turns out, the Government did the opposite of what Norm suggested. Norm was of the view that the citizens of the Province see the royalty changes as a key to getting more Government services (recreation facilities etc), however, what they didn't realize is that jobs would be lost and money would flow out of the province essentially forcing AB Gov't to back track on some or all of the royalty rate changes. If the AB Gov't doesn't make some changes to their earlier decision they will be forced to "incentivize" oil and gas back into the province. As reported yesterday, it would appear that Norm was right and the Government is considering changing their position.

Norm sees the "old time hockey" scenario starting to play out in the natural gas market. What he means is the following:

- A) Costs have declined
  - Trucking costs are down 50% from the highs
  - Service costs are down 50% from the high
- B) Rigs are available with good crews to man them
  - Implications: A more skilled crew can drill holes in a quicker more efficient manner (6 days vs. 10 days) thus dropping your day rate costs
  - Finding and development (F&D) costs then come down
- C) As money has left the patch, competition for assets/opportunities has declined

Essentially, good operators (Dave Johnson at Pro-Ex, who Norm Talked to this morning) can now do business without attracting a lot of attention (like 7 years ago). If you were wondering, Norm did buy pro-ex today.

Furthermore, the consolidation among natural gas companies is beginning. Ryder has been acquired; Cyries was taken over yesterday etc. The combination of Iteration and Cyries has created a "go to" name in the patch. Other names that he likes in the space are Crew Energy and Celtic Energy.

Another name that Norm likes is Hudbay. Hudbay is trading at \$15 with \$5 cash so you are getting the stock for \$10. He thinks Hudbay is a take over candidate.

**Craig Porter: Resource Fund, Resource Performance Fund, CIBC Resource Funds**

**What is going on currently in the market?**

Money flows are the biggest issue facing the market - Supply and Demand story still in tact: I'm comfortable with the supply story and believe that demand is still strong for raw materials however; stocks have "de-coupled" from the commodities.

As investors we own stocks, in an environment where there is fear of a slowdown/recession and you are facing a job loss or your house (which is levered) is declining in value, you are not buying stocks; more likely selling.....funds are flowing into cash.

Money flows are causing the declines in the market vs. an actual global recession.

Commodity prices remain strong and yet the commodity stocks are selling off dramatically (flow of funds). I think stocks are cheap, but can remain cheap for a while. In the 90's commodity stocks were dirt cheap for years while funds flow was going to tech stocks, today the funds flow is going to cash.

What are you doing differently now vs. what you were doing a year ago?

Repositioning in large cap stocks. In the gold run-up of the last month the large cap stocks moved quite dramatically where the intermediates and juniors did nothing.

The market wants liquidity.

**Do you prefer to own natural gas or oil stocks?** Gas looks poised for better gains, why?

Gas stocks are firming:

\$8 gas = \$50 oil

Industrial demand for Nat gas is picking up in the US as substitution away from oil to gas is occurring.

Gas Co's are selling gas forward through the summer at \$8+ and through the winter (08/09) at \$9+ so there is greater visibility on earnings.

Finally, the C\$ has fallen from 1.10 to .96. This has had a beneficial effect on gas co's.

**Frank Mersch & Ryan Tyler: Cdn Equity/ Cdn Hedge; Cdn Performance Fund II;**

**How have you been re-acting to the current market? Have you been trading more?**

In terms of trades, it hasn't been too extensive. Trades have been more from the short side (namely Suncor, Barrick, Kinross, imperial oil). Now with oil and gold pulling back those are starting to make some more sense.

On the beaten down buy side, I've been inclined to accumulate good stocks, falling on illiquidity that I plan to hold for a bit longer than just a trade - i.e. 3 - 6 months. In this category I've been adding RIM, Absolute Software, Sandvine, Arise, Evertz, Sirf. Sectors such as base metals, financials may not be making much of a comeback any time soon. That said, there certainly could be trades coming over the next few weeks. Sentiment and the volatility indices are at extreme lows and highs respectively, meaning that once these measures turn there will be long-side trades a plenty. But not yet.

Otherwise, the earnings picture has held up so far with the bellwethers (IBM, GE, RIM, Oracle) putting out good outlooks. The next couple weeks will hopefully validate my expectations in the mid and small cap stocks.

OK, here are some bullet points on what's happening in equities Monday, January 21st 2008, mid-day: ... some thoughts on the Cdn Equity fund specifically

As of this minute, the TSX is down 'only' 4.2% versus declines of 7% in Europe - YTD the TSX is still the best performing market amongst the developed world (assuming the US plays catch-up tomorrow post MLK holiday) New sentiment is that not only is the US on the precipice of recession (something I'm still not entirely convinced of given the economic data), but now the 'global growth story' is under threat; there are no particular flashpoints for this expanded negativity, but it seems over the weekend investors got a fair bit more worried interestingly, I would think that the TSX would be down MORE today given this change in thinking - although the materials and energy sectors are down 5% today each, it is hardly a crisis - should the global slowdown story come to the fore, I would expect the Canadian resource sectors to under perform as discussed in the past the Fund has reduced exposure to energy in particular and given that the stocks (Suncor, CNR, Imperial Oil, etc.) are now back to where they were back in March 2007 (oil prices closer to \$65, instead of today's \$89) - it looks like time to cover some of the shorts the Materials sector has been held up YTD by the AG stocks and gold - this past week the agriculture stocks have come under fire and a few analysts have questioned the various pricing assumptions of the underlying commodities and the stocks have lost their market darling status; on the other hand the gold stocks have come off but not far enough for my liking and I remain short about 3.5%

USD continues in stealth rally mode and it is now higher than it was back on Oct 31st when the Fed cut 50 basis points - the view that because the Fed will be cutting rates that the USD is poised to fall (and commodities, namely gold, to rise) still strikes me as naïve; the 10yr US Treasury bond has already rallied 65 basis points in the past 3 weeks, so it's not like the market hasn't seen rate cuts coming; in addition within the last week two high-placed officials at the European Central Bank have admitted that growth there will be weaker than they've been letting on and that rate cuts are in the offing, meanwhile the Banks of England and Canada are both clearly in rate cutting mode; portfolio flows out of Canada have been weak and could get weaker - the fund remains unhedged to it's USD/CAD exposure and hence would benefit from further CAD weakness

Financial sector - the move lower might be close to coming to an end. Both US and Canadian banks are off to the tune of 12% YTD (so much for being defensive). That said there are no shortage of players out there willing to kick in capital to shore up balance sheets with several of the name brand US financials taking money from the Mid-East and sovereign wealth funds in recent weeks (even CIBC's equity raise was rather well received) we'd be looking at a much bigger problem if these ailing financials were looking for capital and couldn't find willing investors

OK, so with all that said, how does one position the Cdn Equity Fund?

As in recent weeks there has been a move towards larger cap, better diversified (i.e. more defensive) companies (Oracle, Cisco, Nokia, etc.); with that said however, the reality is that the small-cap exposure is still material and small-caps are being dumped en masse (the venture exchange is down 8.2% today) amongst the tech sector, the emphasis is on high quality companies with highly predictable and growing cash flows (Oracle, Akamai, Cisco, Nokia, RIM) and smaller-cap companies with strong technology and large secular opportunities (Absolute Software, Dragonwave, Sandvine, Intermap, Sirf) in the recent past, the news from the tech sector has actually been quite good, repeat, quite good - earnings at Oracle, AMD, Lawson Software, IBM, RIM have beaten expectations and company outlooks have been strong. Meanwhile Oracle agreed to acquire BEA Systems (web services)

As for bellwethers, Microsoft and Nokia report later this week and should provide further direction within resources the fund will remain underweight metals (short gold, although the gold stocks become interesting again should the metal get back below \$800) and will be accumulating Ag stocks over time after having trimmed some in earlier weeks the AGRICULTURE NAMES are still very good longer term, although the stocks clearly got ahead of themselves as eluded to above, ENERGY IS ALMOST AT CHEAP LEVELS, and if there isn't a big pullback in oil (to the tune of maybe \$15-20) I would be a buyer of the oil sands companies, as well as the larger internationals (Petrobank, Addax, etc)

The fund is currently long roughly 90%, short 5%, cash 15% - that said, the pain is going to continue as time passes should investors be rotating out of stocks and into other asset classes, particularly out of small-caps (Absolute is down 16% today) with that in mind, pricing in the equities vs. bonds still looks very appealing and over the course of the year or eighteen months today's pricing will likely look like a great buying opportunity that doesn't provide a lot of hope for the next several days, but in the longer-term I'm still confident of the positioning

Should this lengthy dissertation seem not quite adequate let us know and we can answer any questions that remain.

**Prakash Hariharan: Co-Manager; Diversified Income Class & Long/Short Income Fund**

## Are you starting to look at bank stocks?

I've been doing some homework on the banks because there is a big trade coming if you can pick them up near the bottom. We aren't there yet but I want to be prepared. In the income funds we have started a position in CIBC, looking to build a 3% weight over the next 3-4 months.

Nortel V. The banks: The issues facing the banks are completely different from the issues facing NT 7 years ago. Nortel was involved in improper revenue booking. Whereas the banks are writing down assets (and going too far with the write downs). I believe the banks are going over board on the write downs/booking of losses.

Why? Let's look at the actual write-offs

- A) Increased provisions for loan losses
- B) Write-down of current assets due to counterparty risk

Examples of counterparties (mainly a USA issue) Mbank and MBIA.

Let's now look at the assets of a bank: 3 types

- A) Type 1: govt T-bills and other assets that have known and stable values
- B) Type 2: equities, bonds, fixed deposits, loans
- C) Type 3: Collateral debt Obligations (CDO's) SIV (structured investment vehicles) derivatives (swaps) all these assets require computers to price the assets. These assets are generally synthetic in nature and values are not always known with certainty.

It is the type 3 assets that are being written down and due to poor risk management, the banks are discovering type 3 assets that have been located in the type 2 category!

This is why we are consistently seeing increased write-offs from the banks (Citi, Merrill, CIBC), because they are discovering these assets as they dig deeper and values are not known.

Type 3 assets are being written down due to counterparty risk. The initial view of the banks was if I'm going to hold/invest/originate these SIV's, I want a guarantee in the event of default. Counterparties (Mbank, Mbia) were paid a % fee for taking on the risks of the assets. Effectively, banks were transferring the risks of these assets off their balance sheets and onto the external counterparties.

Today: As these assets are defaulting (mortgage securities etc) the counterparties may not be able to guarantee all the assets and therefore:

- A) The counterparties have been selling off dramatically
- B) The assets (which in many cases are fine) are selling off as well.

So what is the opportunity? Why is Warren Buffet snooping around the mortgage insurers? And we are setting up a distressed real-estate fund?

Because the assets have sold off due to counterparty risk. If the assets have no guaranteed party backing them the value of the assets declines (even though the asset has intrinsic value). These assets (Mortgage backed securities for example) have dropped to \$.15-.20 on the dollar and paying high yields. If Warren Buffet comes in and becomes/takes over as guarantor on the asset, inherently the asset will rise in value because you now have a strong counterparty behind it insuring it.

The market may have been paying an insurer 40bps to insure the mbs security; Warren Buffet comes in and says I want 60bps.

Essentially the type 3 assets that have been written down at the banks aren't actually worth zero\$. There is upside potential (assets written down increase in value) if the counterparties change. This is the potential with the banks.

MBS opportunity: a MBS security may be trading at .15\$ on the dollar but there isn't a threat of default. The mbs security continues to pay 10% for a prolonged period of time and the market begins to recognize the stability of the security and the

oversold nature of the investment. The market then decides that the stability of the MBS and quality of asset deserves a higher value (.15 to .50 on the dollar). This is the trade.

**Eric Dzuba; Co-Manager of Diversified Income Class and Long/Short Income Fund**

**As a portfolio manager, are you managing the fund any differently today then you would have 6-12 months ago?**

We're not doing anything differently now than we did six months ago. We still have a mix of more aggressive and less aggressive names. The former would include companies with exposure to strength in the agricultural space as well as others that should benefit from global infrastructure spending.

On the less aggressive side, we have some stocks / trusts in the pipeline / utility square and some REITs (although with the recent volatility in their unit prices, one would think that they were high beta stocks!).

Despite concerns of a slowing US economy, we still think that there's a lot of money that has to be spent in the global economy: people still have to eat, there are still roads, bridges and power plants to be built and now the US consumer has a growing counterpart in several emerging economies. Remember back in the late 1980s how ski resort operators were teaching their employees Japanese? There was a story last week on Bloomberg about how high end resorts in Europe are teaching their staffs Russian. My point: wealth being created elsewhere eventually finds its way into the global system.

Our equity exposure is just over 50 per cent. On the income side, we have been selling sovereign debt and replacing it with some beaten-up convertibles: real treasury yields are negative, while the debt of some energy trusts is trading at yields north on 8.5% at a time when oil is \$90 and natural gas prices look to be stabilizing. While this has added some volatility to the portfolio (despite a bit of shorting against the positions), we think the trade will add return in excess of the extra risk.