LONDON CAPITAL MANAGEMENT

Monthly investment commentary

October 2008

SEPTEMBER HIGHLIGHTS

- Global stock and bond markets roiled amid news of dramatic financial company failings and hastily arranged corporate takeovers.
- U.S. government's proposed bail-out package failed to get approval by the U.S. House of Representatives by the end of September.
- Investors sought the relative safety of gold and short-term government T-bills, causing demand to soar. Gold prices rose $43 to $878 during September, while yields on 3-month U.S. Treasury Bills dropped as low as 0.04% on September 17th.
- Oil (down $14 for the month) and other commodity prices dropped as fears of slowing global growth dampened future demand expectations.
- The Financial sector finished the quarter as the best performing sector in the S&P/TSX.

WAKE ME UP WHEN SEPTEMBER ENDS

The hit song by Coldplay "Wake me up when September ends" probably has a few more fans on Wall Street these days. Hurricane season hit stock markets in September and made it one of the stormiest months in recent history.

Stock markets around the globe dropped significantly in September. The Canadian stock market was among the worst performing indices in the world (see Table 1). The S&P/TSX suffered a double hit in September. Commodity prices sank amid growing expectations that global growth would slow, and (keeping in mind Canada does share a border with Alaska!) the U.S. financial system worries spread to Canada.

On both sides of the border the best performing sectors were the Consumer Staples sector (think aspirin, ice cream and antacids for those volatile September days), and the Financial sector (see Table 2). Yes, the Financial sector did relatively well throughout all of this market turmoil (more on the topic on page 2). In Canada, Research in Motion's modest reduction in future earnings expectations sparked a sell-off in its stock and brought the Information Technology sector down with it. The Energy sector also performed poorly as oil prices declined $14 in September to $101/barrel (West Texas).

Table 1– Summary of major market developments

Market returns*	Sept.	Q3 2008	YTD
S&P/TSX	-14.7%	-18.8%	-15.0%
S&P500 (US$)	-9.1%	-8.9%	-20.6%
S&P500 (C$)	-9.4%	-5.1%	-15.1%
NASDAQ	-12.0%	-9.2%	-21.5%
Russell 2000	-8.1%	-1.5%	-11.3%
FTSE 100 (U.K.)	-13.0%	-12.9%	-24.1%
NIKKEI 225 (Japan)	-13.9%	-16.5%	-26.4%
EAFE (C$)	-14.7%	-17.8%	-26.6%
EAFE (local currency)	-12.4%	-13.6%	-28.5%
Canadian Bond Market	-1.9%	-0.4%	1.8%
World Bond Market (US $)	0.3%	2.7%	2.9%

*local currency (unless specified); price only

The Canadian bond markets were not spared the volatility in September. Credit spreads on corporate bonds widened significantly, government bond yields varied dramatically, and yields on short-term government T-bills dropped as investors sought the relative safety of short-term government paper.

The unraveling of September's events began with continued downward pressure on commodity prices, followed by news that a number of major financial companies (primarily in the U.S.) have fallen into significant financial hardship, and ended the month with a sharp sell-off sparked by the U.S. government's failure to approve a financial system bail-out plan. Phew!

JUST ANOTHER MANIC MONDAY!

Don't like Mondays? In September market watchers had more reason than usual to get the Monday blues. The S&P/TSX experienced significant drops every single Monday in September. Unfortunately, the stock markets weren't just lamenting the end of the weekend and market declines didn't limit themselves to just Mondays.

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What happened? The dramatic headlines and significant concerns facing U.S. and global financial companies has shaken investor confidence and caused significant uncertainty about the stability of other financial institutions. Because credit and liquidity concerns can be wide-reaching, affecting companies in all sectors of the market, we've seen a broad-based sell-off in the markets.

While the problem may have originated from exposure to the sub-prime mortgage market, these financial companies ultimately suffered from a lack of investor confidence, virtually drying up the availability of credit and capital liquidity, and hampering their ability to continue doing business.

Table 2 - Sector level results for the Canadian market

S&P/TSX sector returns*	Sept.	Q3 2008	YTD
S&P/TSX	-14.7%	-18.8%	-15.0%
Energy	-20.3%	-27.6%	-11.3%
Materials	-18.8%	-33.7%	-16.7%
Industrials	-17.6%	-13.4%	-13.0%
Consumer discretionary	-10.2%	-4.6%	-28.1%
Consumer staples	-4.7%	-5.1%	-10.3%
Health care	-15.3%	-11.4%	-24.9%
Financials	-2.2%	1.7%	-11.8%
Information technology	-41.6%	-38.0%	-37.1%
Telecom services	-9.2%	-5.2%	-15.7%
Utilities	-15.0%	-16.4%	-17.5%

*price only

DEAL. NO DEAL.

Credit, and the ability to access cash when you need it, is what greases the wheels of a free economy – and the negative effects of a lack of liquidity can be swift and far-reaching. We have seen governments and central banks take steps to ensure that liquidity remains in the capital markets, but the lack of confidence in the U.S. economy, and global financial systems is now pervasive among investors. This uncertainty has lead to severe volatility.

Throughout the month, the U.S. government scrambled to inject money into the capital markets, and hastily arranged suitors to take over troubled financial companies, but by mid-month it became clear that events would continue to spiral unless more was done. Hence, the announcement of the now infamous 'Wall Street bailout', otherwise known as Troubled Assets Recovery Plan (TARP).

By targeting subprime mortgage related assets (a.k.a. the financial weapons of mass destruction) the government would buy troubled assets from U.S. companies - giving these financial institutions the cash they need to operate in the short-term, and a clean 'subprime-free' bill of health. The 'rescued' would then have improved credit ratings - making their business more palatable to would-be investors and lenders alike. In a nutshell, the desired effect of the TARP would be to stop the credit crisis, and breathe fresh life back into Wall Street. On September 29, 2008 the U.S. House of Representatives, primarily sighting costs to taxpayers, said 'no deal' to the bailout package - sending it back to the drawing board and setting off a one-day free-fall in the markets.

ARE ALL STOCKS FALLING?

Despite all the negativity in capital markets, some sectors and many companies, including some U.S. financial companies, have avoided significant de-valuation of their stock prices. For example, such well known names as bank Wells Fargo & Co., financial services company JPMorgan Chase & Co., and P&C insurer ACE Limited, to name just a few.

A special note about Canadian Financials companies. The Canadian Financial sector has not, and will not be immune to the turbulence arising from the credit crisis in the U.S. Having said that, Canadian banks are not as significantly susceptible to the same issues as their American counterparts. While surprising to some, the Canadian Financial sector posted the only positive return for the quarter, and remained one of the top sectors during the challenging month of September (see Table 2). In contrast to its U.S. peers, the Canadian banking system has a number of key distinguishing features, including:

- more highly regulated,
- centralized around a relatively small number of large, stable financial institutions with diversified assets and revenue streams, and
- more conservative capital constraints and a more solid funding base than the troubled U.S. investment banking firms.

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Many Canadian financial companies continue to have solid business models and could continue to fare well, on a relative basis, as investors regain confidence in the financial sector in general.

These bright spots in both the U.S. and Canadian markets shows signs that investors continue to recognize some businesses as having solid business models that are likely to succeed despite the current market challenges. As the current situation moves passed this acute stage, we hope to see a greater number of stocks responding to their fundamental outlook, and not simply getting swept up in the broad negative sentiment towards equities that we are currently seeing.

WHEN WILL MARKETS RECOVER?

The exact timing of a recovery cannot be predicted and we caution against those who believe they can. Currently the markets are reacting to event and company-specific news. Markets will continue to be volatile and further losses are possible as long as there remains significant uncertainty about the health of the U.S. financial system, and liquidity constraints begin to ease. To put it simply, we need to see money start to flow between businesses, and move beyond the stage of government bailouts.

We do not expect a 'quick fix' to these events. The failure of the $700 billion U.S bailout plan is evidence of this. Regaining investor confidence in the U.S. economy and the U.S. financial system will take time. As Warren Buffett has been famously quoted as saying 'You find out who's not wearing a bathing suit when the tide goes out'. In other words, as the markets decline and investors demand clarity about the risks and opportunities of each company before committing their money, the true financial picture of those companies will become clearer.

It may be some time before the alarming headlines subsides, and equity markets return to assessing the fundamental outlook for companies on a stock by stock basis – but they always do. This is a necessary weeding out of financial excesses, bad debt and weak business models that is required to build a base for investor confidence and for sustainable market growth to emerge. The start of every market recovery begins with a washing out of flaws in the capital markets. Nobody likes to see significant drops in the capital markets, but just like Buckley's cough medicine, a market correction 'tastes bad, but it works'.

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