

# Tetrem Capital Management Ltd.



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Living in one of the coldest cities on the planet, Winnipeggers aren't known to happily anticipate the onset of winter. This is particularly the case after a summer of exceptional weather and a mosquito population that went AWOL. Thanks to the terrible performance of global equity markets throughout the summer and early fall, all of us at Tetrem are more than happy to transition into down-filled parkas. While the days will be shorter and the nights much colder, we believe equities are poised to reclaim a summer of investment discontent.

It has been our view that the decade-long bear market for U.S. equities reached its lows in the first quarter of 2009, and that we are in the early stages of a bull market. Volatility will persist as the tug-of-war between deflationary and reflationary forces continues. Reflationary policies will ultimately prevail, barring a major policy error on the part of government officials, which is the primary risk. It is more important than ever for investors to have fortitude and take a long-term viewpoint to avoid being a casualty of the volatility. Memories of the 2008 "financial earthquake" run deep, and the fear of a repeat arises with each financial aftershock. Although each aftershock has harboured economic risk and led to market volatility, the bull market has marched on. We expect the pattern to continue. The alternative of investing in government bonds at historically low yields, or hiding in cash at no yield, is unappealing. This is particularly true when equities are outright cheap, offer a yield premium to government bonds and are priced for a 25% decline in earnings.

Recent market volatility has been driven by the sovereign debt aftershock, of which the epicentre is Greece. Much has been written about the country's profligate ways while pseudo-scholarly pieces have attempted to divine multiple paths to a solution. To our simple Midwestern way of thinking, the

situation is easier to understand through an analogy. The Germans decided to host a party called the EU (catered by the French). Rightly or wrongly, we've blamed Germans for letting the situation get out of hand (sorry, guys). They invited a large number of guests to make sure it was going to be a big party and, in particular, one that the rest of the world would look upon with envy. A strong euro was served to all attendees, most of whom could handle it.

The Greeks were invited even though they had a history of financial substance abuse. Not wanting to be left out of a party that promised good times for all, the Greeks came and even managed to put on an Olympic Games. Germany's manufacturing base benefited from a party animal that helped keep the euro globally competitive. German exports grew and unemployment declined while the Greeks continued to binge on cheap euro financing that allowed its public sector to expand without anyone having to pay pesky taxes. It sure didn't hurt that the Greeks bought more Mercedes and BMWs than they could afford. Everyone was happy, and it was a great dysfunctional relationship that worked as long as the party kept going. However, early in 2010, "Stairway to Heaven" was queued, the lights went on and the party was over.

The Germans have a choice. They can let the Greeks drive home inebriated on excessive debt, with the near certainty that they get into a fatal crash, taking innocent bystanders with them. This would be morally wrong, which is why in the real world a legal liability exists for the host if an intoxicated guest has a car accident when leaving a party. The analogy may not be perfect, but it is highly doubtful that policymakers in Berlin and Brussels did not know that Greece had an issue with financial substance abuse (limited tax collection, etc.) when the invitations to join the EU were sent out.

Unfortunately for Germany, there is little choice but to write a cheque to clean up after the unruly partygoers. At least, this was our thinking up until mid-August. Since then, it has become clear that the Greek government has done little to abide by its agreed-to austerity measures, i.e. there is little sign of sobriety! Writing a cheque would only delay the inevitable and lead to more of the same down the road.

So now Germany, with the help of the rest of the EU's sober partygoers, is in the midst of engineering an intervention in order to break the dysfunctional relationship.

Interventions aren't easy. Ultimately, whoever has the substance abuse problem has to agree to reform, and this is where Greece is now, though some citizens are still in the denial stage. European countries cannot unconditionally bail out their friends in the south – doing so would ensure that the problem persists. To get help, Greece first needs to make the painful decision to restructure. If it does not, their friends' best choice is to cut ties and do what can be done to limit the fallout back home, particularly as it relates to the banking sector. To convince Greece of the stark choices, its European friends have taken on roles of bad cop and good cop.

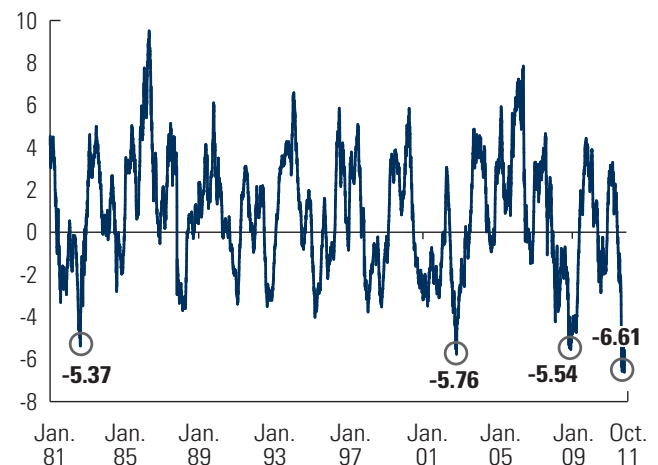
The good news is that there is strong motivation to make the intervention work. The economic cost to Europe of ignoring the problem and allowing it to metastasize are estimated at four to five times the cost of stopping it today. Greece would be worse off, tax riots notwithstanding.

This is important because we are approaching an inflection point in the aftermath of the 2008 financial crisis. Europe needs to avoid a policy blunder that could trigger a global recession. A reasonable intervention in Greece will set the stage for a sharp rally in equity prices but it will not be an economic elixir. Europe will not find a solution that fixes its debt and demographic problems overnight. It will be tough economic slogging for a few years, at the very least. North American equities do not need a strong Europe to rally; they just need Europe to avoid a sharp economic contraction.

In early 2009, there was a risk that the world was on the brink of "Great Depression II." However, while the risk existed, the odds were against that outcome. Investing is never certain; it is an exercise in probabilities. Equities today are supported by tremendous value and offer compelling opportunity. In our work, the average upside for equity securities in Tetrem's Canadian and U.S. portfolios was over 70% within our three-to-five-year framework, and over one-third were doubles. The scenarios we use to derive each outlook are conservative; they do not incorporate pie-in-the-sky earnings and valuation forecasts. We have been using the recent volatility to position portfolios to profit from the value opportunities that are being created in the current environment. It has been difficult but we have had the courage of our conviction to sell what has held up in order to buy what offers the best value.

An old stock market adage is that making money in the market is actually quite simple over the long term: "all" you have to do is sell greed and buy fear. Like many adages, it is much easier said than done. Buying into fear is an investment cornerstone at Tetrem and we believe we have been executing on this philosophy. The accompanying chart from Credit Suisse measures levels of global market "risk appetite" over the past 30 years. Recent readings of extreme low risk appetite indicate a level of fear in the marketplace that is consistent with levels that have historically preceded significant equity rallies. Macro risks are elevated once again. History has shown that this is precisely the time that probabilities favour investors who accept risk.

## Global Risk Appetite



Source: Credit Suisse

Chart 1: According to Credit Suisse, the global appetite for risk has reached its lowest level in 30 years, indicating a high level of fear. Historically, such low points have been followed by strong rallies in equity markets.

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