

## DK EQUITY GROWTH FUND

### Quarterly Report March 31, 2000

#### *Rates of Return*

	<u>3 Mths</u>	<u>1 Yr</u>	<u>2 Yrs</u>	<u>3 Yrs</u>	<u>4 Yrs</u>	<u>5 Yrs</u>	<u>6Yrs</u>
<b>DK Equity Growth Fund</b>	<b>-4.3%</b>	<b>9.1%</b>	<b>-13.1%</b>	<b>-10.1%</b>	<b>-2.2%</b>	<b>7.9%</b>	<b>7.5%</b>
Nesbitt Burns Small Cap Index (Unweighted)	11.5%	30.1%	-2.0%	1.6%	4.6%	8.4%	5.0%
TSE 300	12.8%	45.5%	13.6%	19.2%	19.4%	19.1%	16.1%

Technology stocks continued to dominate the TSE300 and Nesbitt Burns small cap indices and took them higher in the first quarter of this year. In our December 31, 1999 report we pointed out that Nortel and BCE accounted for roughly 27% of the TSE300 index by weighting at year-end. The TSE300 was ahead by 31.7% last year but without Nortel and BCE the advance would have been 8.8%. In the first quarter of this year the same trend has continued. By removing the impact of BCE and Nortel, the quarterly index return drops to 5.9%.

#### 3 Mth returns ending March 31, 2000

TSE 300	12.8%
TSE 300 ex BCE	9.5%
TSE 300 ex BCE, Nortel	5.9%

We continue to steer clear of many of the technology-related stocks because of valuation extremes. We cannot make any sense of the valuations placed on the majority of technology stocks.

On March 9<sup>th</sup>, for a client presentation we were making, we looked at the valuations of the high-tech darlings of the Canadian market, Research in Motion and Ballard Power (the new "new economy") and compared them to the valuations of the old-line Canadian conglomerates, Canadian Pacific, Edper Brascan, Onex and Power Corporation, and the Big Five banks. What we found struck us as, at best, ridiculous.

As outlined in the following table, the combined market capitalization of RIM and Ballard was \$28.4 billion and the combined market capitalization of the Big Four conglomerates of the Canadian economy was \$22.1 billion. In short, you could buy RIM and Ballard, promising technologies with \$96 million in revenues in 1999, for \$28 billion, or you could buy the combined empires of CP, Gerry Schwartz, Edgar and Peter Bronfman and the Desmarais family, with a total of \$20 billion in revenues and hundreds of thousands of

employees, for \$22 billion and also put \$6.4 billion in the bank for a rainy day. We suggest that the momentum market has placed too high a valuation on RIM and Ballard.

If you wanted to play with even bigger stakes, on March 9<sup>th</sup> you could buy BCE for \$112 billion or you could buy the four conglomerates and the big five banks for \$100 billion and put \$12 billion in the bank. BCE may be a great company but the valuation seems extreme when it is worth more than the banks and the conglomerates combined.

Since we put together the following table, the market has taken some of the air (helium?) out of RIM and Ballard (roughly 5 weeks later RIM has a market cap of \$3.8 billion, down 72% and Ballard has a market cap of \$9 billion, down 39% from March 9<sup>th</sup>) and has increased the market cap of the conglomerates from 10-20%. However, the new economy valuations given to RIM and Ballard are still extreme.

**Millions of \$, 1999 trailing fiscal year end, as of March 9, 2000**

**Conglomerates**

				<b>Valuation</b>	
	Mkt. Cap.	Revenue	Earnings	Trailing P/E	Forward P/E
CP	\$9,000	\$11,400	\$594	15	9
EBC.A	\$4,800	\$5,975	\$423	11	8
OCX	\$4,200	\$1,500	\$294	14	15
POW	\$4,100	\$1,000	\$420	10	12
	<u>\$22,100</u>	<u>\$19,875</u>	<u>\$1,731</u>		

**Big 5 Banks**

				<b>Valuation</b>	
	Mkt. Cap.	Revenue	Earnings	Trailing P/E	Forward P/E
BMO	\$11,700	\$1,500	\$1,400	8	8
BNS	\$13,050	\$13,500	\$1,550	8	8
CIBC	\$14,350	\$14,400	\$1,030	14	10
RY	\$17,850	\$14,200	\$1,760	10	10
TD	\$21,000	\$10,400	\$2,500	8	12
	<u>\$77,950</u>	<u>\$54,000</u>	<u>\$8,240</u>		

**“New Economy”**

				<b>Valuation</b>	
	Mkt. Cap.	Revenue	Earnings	Trailing P/E	Forward P/E
BCE	\$112,000	\$14,215	\$1,935	58	53
NT	\$245,000	\$32,220	\$2,500	98	95

**New “New Economy”**

				<b>Valuation</b>	
	Mkt. Cap.	Revenue	Earnings		Forward P/E
RIM	\$13,728	\$71	\$10		900
BLD	\$14,700	\$25	(\$61)		n/a
	<u>\$28,428</u>	<u>\$96</u>	<u>(\$52)</u>		

Another example of extreme valuation is Nortel. A recent article in the National Post put the massive increase in Nortel’s valuation in perspective. Firstly, the article pointed out that Nortel’s CEO, John Roth, had done an even greater job in “enhancing” shareholder value than legends such as Jack Welch of General Electric and the late Roberto Goizueta of Coke. After 30 months on the job, the market value of Nortel increased by \$122 billion U.S. In an attempt to put this number in perspective the article points out that for US\$ 122 billion you

could buy General Motors, Sears, J.P.Morgan, Nike, Mattel, Quaker Oats, Bethlehem Steel, the entire U.S. airline industry, and still have enough left over to build five new Millennium Domes for the city of London.

This is not the first time in history, not even recent history, that valuation extremes have taken hold. We remember clearly the cult that developed around conglomerates like ITT and Ling-Temco-Vought in the 1960's. At that time, these market darlings attracted Internet-like valuations. When it ended, the conglomerates declined by roughly 80% in value. Subsequently, the "Nifty 50" stocks (Polaroid, Merck, Coke, Avon, etc.) traded at then unheard of multiples in 1973 before many were trashed by a like amount.

We would argue that valuation extremes are far greater today than at any time in the past 30 years. We were looking at a piece of research done by Ned Davis Research in the U.S. recently. It suggests that the outrageous valuations on the "Nifty 50" back in 1973 were modest compared to some of today's valuations. The research shows that in 1973 the most expensive 20% of the S & P 500 index had a P/E ratio that was 3 times the median P/E for the remaining 80%. Today the top 20% of the S & P 500 commands a P/E of 4.8 times the rest of the market.

The surge in valuations for technology stocks has concealed a bear market. As of the end of February, according to statistics from Salomon Smith Barney, 3 out of every 4 stocks in the S&P 500 index were down 20% or more from their 52-week high. The average decline throughout the index was 32.5%. The Toronto statistics are similar. Furthermore, if you look at the number of advancing stocks versus declining stocks the figures show that more stocks have been declining than advancing in the U.S. and Canada since early 1998. As we have been saying repeatedly since then in our quarterly reports, an ever-shrinking number of wildly overvalued stocks have been pushing the market indices higher in the past two years.

We note with interest that this bull market in absurd stocks and bear market in solid companies has led one of the legends of the money management business to simply walk away in frustration. Tiger Management, a New York-based fund run by Julian Robertson, one of the most successful value investors ever to work on Wall Street, announced in late March that they decided to close up shop and distribute the roughly \$6 billion in managed funds back to their investors.

We continue to press forward, holding to the same basic principles we have always adhered to. As always, we are looking for smaller, faster growing companies; companies with distinct competitive advantages; strong balance sheets; financially committed management teams; sales and earnings growth of at least 15% per annum; return on equity of 15% or more; and **we try to buy them at reasonable valuations.**

Companies that fit this type of profile continue to dominate your portfolio. We also find some of the most attractive opportunities in areas that are currently out of favour with investors such as the energy business, base metals, and industrial products. As we have pointed out in recent reports, rarely have we seen the fundamental environment for energy stocks and base metals stocks so positive yet the share prices so inexpensive.

We know we hold value because we have been consistently losing companies to takeover bids for the past 18 months. We lost **Tritech Precision** (auto parts) last quarter to a cash bid of \$33 per share when the stock was trading in the market at \$23. We also lost **Electrohome Broadcasting Inc.** which owned 11% of CTV as a result of a BCE Inc. takeover bid for CTV.

WorldWide Fiber (now called 360 Networks) has made a bid for our **GlobeNet Communications**, a Bermuda-based fibre-optic cable company. The bid is a 75% premium to the market price of GlobeNet before the bid. GlobeNet is laying a South American undersea fibre-optic cable link that will form a core part of 360 Networks' worldwide strategy. We recently had Greg Maffei, the CEO of 360 Networks and the former CFO of Microsoft, in our office to update us on 360's strategy and we foresee continuing as shareholders as our GlobeNet stock is exchanged for 360 Networks' stock.

Furthermore, just after the end of the quarter, Unocal announced the intention to pay \$10.10 cash for our **Northrock Resources** when Northrock was trading at just over \$6. There is a massive consolidation underway in the energy business because the stocks are trading at a level where it is cheaper to buy reserves and production in the stock market than it is to explore for it. Unless valuations change we expect more takeover activity in the portfolio.

A few of the notable names we have added to the portfolio over the last quarter are **Hummingbird Communications**, **Leitch Technology**, and **MDS Inc.** These companies have positive growth profiles going forward, trade at reasonable valuations, and have strong balance sheets.

Hummingbird is a leader in the development of enterprise software solutions that provide access to all business-critical information and resources, with estimated fiscal 2000 revenues of over US\$230 million. We forecast the company will enjoy significant revenue and earnings growth going forward, however our average cost of about \$55 was just over 20 times our current year's cash EPS estimate. Furthermore, the company recently launched an Enterprise Information Portal (EIP) solution. An EIP is a single screen created to solve the Information Age Paradox – Information has never been more accessible, but accessing the right information has never been so difficult. Each screen has all the information a worker needs, with more information easily searchable – making better utilization of corporate knowledge a competitive advantage. This market, currently estimated at several billion dollars, is cited by IT departments as second only to e-commerce as a priority going forward.

Leitch designs and manufactures analog/digital electronic broadcasting equipment. Fiscal 2000 revenues (April) are forecast to be somewhat flat year over year, at about \$165 million, reflecting customers reluctance to further invest in analog technologies, while delaying investing in digital until a clear business case emerges. Going forward, we believe the growth prospects for Leitch will continue to improve, driven by the market transition to digital broadcasting (for HDTV), video over the internet, and video sent via cable and telecommunications. Given the positive long-term outlook for Leitch, we believe the stock,

which trades in the low \$20's, versus our F2001 EPS of \$1.00 per share, represents good value.

MDS provides products and services to health care providers, including contract drug discovery and development research services, with F1999 revenues of almost \$1.2 billion. We also have a position in **Phoenix International Life Sciences**, a contract research firm that provides services to pharmaceutical and biotechnology companies. In February, MDS made an offer to buy Phoenix for cash and shares, with the transaction expected to close in early April. As profitable and growing operating companies, both provide exposure to the Biotech sector without the inherent risks associated with investing in individual companies and/or drugs. MDS recently raised \$82.5 million in a private stock sale of its drug research division, Proteonics, which it intends to take public within one year. The private placement values the division at \$600 million, or almost 25% of the current market value of MDS.

As of March 31<sup>st</sup>, the 10 largest holdings were:

Lionore Mining	5.4%	nickel
UCAR International	4.0%	graphite electrodes
Jubilee Mines	4.0%	nickel mining
Ritchie Bros. Auctioneers	3.7%	industrial equipment auctions
Western Star Trucks	3.4%	trucks, buses
Winpak Ltd.	3.3%	packaging
Genesis Exploration	3.2%	oil and gas
Unican Security Systems	3.0%	locks and keys
Globenet Communications	2.9%	fibre-optic cable
Angiotech Pharmaceuticals	2.9%	pharmaceuticals
	<u>35.8%</u>	

As of March 31<sup>st</sup> the portfolio breakdown by industry group stood as follows:

Metals	14%
Oil & Gas	26%
Forest Products	4%
Total Resource	<u>44%</u>
Consumer Products	7%
Industrial Products	24%
Transportation	2%
Communications	2%
Merchandising	5%
Financial Services	1%
Biotechnology	7%
U.S & International	7%
Miscellaneous	1%
	<u>100%</u>