



September 30, 2007

## **Cause and Effect Crisis Equals Opportunity**

Recently I received a phone call from an old friend and real estate executive in San Francisco. He presented a plan: Raise \$20 million dollars and buy into the collapsing U.S. housing market by purchasing a large portfolio of foreclosed homes, in this case, in Sacramento, California. Buy cheap real estate, lease the premises back to the individuals who could no longer pay the mortgage that they could not afford in the first place, cover one's cost and eventually count your chips as real estate recovers. In general, the concept was appealing to me, as is so often the case in the world of finance "Crisis Equals Opportunity".

The depth and breadth of the sub-prime mortgage situation forced a market correction in August as investors around the globe began to digest the extent of the credit crisis. Alen Abelson, a lead writer for Barron's, aptly described the cause of the sub-prime mess: "It's easy to see what got us into this bloody bind: a breathtaking binge of mindless borrowing accommodated by legions of lenders uninhibited by scruple of any sort, mightily aided and abetted by Wall Street's ingenuity in discovering new ways to create and peddle leverage. And of course, by snoozing watchdogs, like the Fed."

Stocks corrected sharply and fear gripped the financial markets. The correction was notable and will hold a place in stock market corrections history along with the likes of the 1998 Russian debt crisis, the 2000 dotcom technology bust, the 9/11 terrorist attack and a host of other corrections that have sent investors to the exits as greed takes a back seat to fear. For long time investors with good memories, these corrections generally look and feel the same; painful daily news as wealth is eroded across the board. Each correction has its "cause and effect", yet historically each correction has been met with a comeback. Sellers at the bottom paid a price for the exit, and the buyers at the bottom reaped handsome profits.

Cause and effect. The "cause" is now clear yet the "effect" remains uncertain. The remedy lay at the feet of the Federal Reserve Board, and accordingly, it acted much in the same manner as it has in past market corrections: throw money at the problem and stem the tide. In September the Fed's cut interest rates an eye popping 50 basis points (remember we were in a period of rising rates before this event erupted), and provided liquidity injections as did a number of central bankers around the world. The equity markets roared back to life and investors gave a sigh of relief. In the investment world, the timing of corrections is most unpredictable, however the right move to make in these times is predictable; don't sell into the lows, take a deep breath, and if you have cash, smile and hunt for opportunities. Cause and effect. Crisis equals opportunity.

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## **Brownstone U. S. Total Return LP**

Our Brownstone American Total Return LP was front and center over the quarter, reacting daily to news floating out of the U.S. regarding the crisis in the credit markets. Although some sleep was lost over the worst days of August, we concluded the quarter up 2.05%, inline with the benchmark S&P 500. Our LP, initiated six months ago, has a total U.S. dollar return of 17.61%, which is 9.17% over the S&P 500, a most gratifying return considering the volatility and general bear market conditions that plagued the third quarter. We witnessed a sharp rebound from the lows of August and were pleased with the LP's ability to weather the storm. The LP holds approximately 30 U.S. equities, each screened based on specific financial metrics. The Canadian / U.S. dollar at parity has been a sea-change for Canadians and offset some of our U.S. dollar gains, however we avoid currency predictions as a basis for investment in the LP.

The new pricing parity with the U.S. will cause a mini-revolution in the Canadian consumer products arena. The mathematics for Canadian consumers has simplified, and they will demand lower prices from Canadian retailers as the embedded confusion over the relative price of Canadian and U.S. goods has cleared. For example, the CEO of Porsche Canada recently issued a press release indicating an across the board cut in the price of its luxury automobiles. Its customers were fleeing south for large savings. At Brownstone we have avoided investments in companies that hinge competitiveness on the back of the previous currency spread. We look forward to the final quarter of 2007 and are comfortable with the relative valuation metrics many equities hold today.

## **Brownstone Team**



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