

# The Lychak Letter

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*“A Quarterly Analysis of Bond and Stock Market Trends Worldwide”*

September 2000



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## Note from the Editor:

I wanted to apologize for the tardiness in the issuance of this newsletter. I had several changes in my life in the last few months that seemed to take up my time. These changes have been very positive and have made this a wonderful year. Subsequent issues of my newsletter should continue on a quarterly basis from this date. I hope you enjoy this issue!  
Sincerely,

*Patrick Lychak*

## Government Yields / Currency

Term	Cdn Govt Yield	US Govt. Yield	Cdn Rates Prime 7.5 % Bank 6.0 %
3 mo	5.63 %	6.28 %	US Rates Prime 9.5 % Fed. 6.5 %
6 mo	5.74 %	6.36 %	
1 yr	5.88 %	6.17 %	\$CDN = 0.673
5 yr	5.84 %	6.00 %	
10 yr	5.74 %	5.73 %	
30 yr	5.47 %	5.67 %	

In my last newsletter I stated that the US Federal Reserve was likely to continue raising rates which is exactly what they ended up doing. Recently, on August 22, the Fed left it's key rate at 6.5% (the highest level since 1991) and said, "the expansion of aggregate demand is moderating toward a pace closer to the rate of growth of the economy's potential to produce." You would think the Fed could just use plain English but the reality is the Fed is not sure what it will do in the future, and this type of text is indicative of this. Overall I feel the Fed is happy that the stock markets in the US have begun to behave more rationally, and that inflation still has not been a concern. As long as this is the case I do not feel rates will rise at the next scheduled meeting on December 19<sup>th</sup>. The only thing that could cause rates to rise is if the escalating price of oil started to go even higher from current levels resulting in more inflationary pressures. I will talk

about factors affecting the price of oil later in the commodity section of this issue. In Canada interest rates still lag those of the US as is depicted in the above diagram of Government Yields. If you were wondering why the Canadian dollar is so weak, it is because Canadian rates are lower than the US. As a result Investors tend to buy US bonds as opposed to Canada due to the higher yields US bonds offer. That's the only reason for the weak Canadian dollar and it is likely to remain weak because the government wants to keep rates low in order to keep the economy stimulated. Overall I expect rates should stay the same for the next few months.

## North America Stock Markets

Back in March I summed up my opinion by saying, "the technology sector is extremely vulnerable to a correction". I also said that now was a good time to ask, "exactly how many times earnings are the companies trading at". Later in March the technology sector began a sudden and dramatic drop that caused many investors to suffer large losses (which I had warned was likely). However what has happened recently is that we have had a recovery somewhat in the technology sector as most stocks have rallied from the lows of May. I believe that the correction that began in March was a major one. Usually when major corrections occur the market does not just go down quickly, but gradually goes down over several months with rallies in between. The rally that has occurred in the last three months I expected to happen. It is quite typical because after a sudden large drop a rally will develop as investors believe that prices have dropped too much and that prices are likely to recover. This rally I believe is close to peaking again and the technology sector is likely to gradually start going down and gain speed as we approach Fall. I feel that the technology sector is likely to reach previous lows reached in May and some stocks may go even lower. My rational is that the overvaluation in this sector is still high so there is little upside and the downside is immense. Gradually as investors have losses they will question the price they are paying for a stock and earnings multiples will once again become important. At this point I have again reduced all technology holdings.

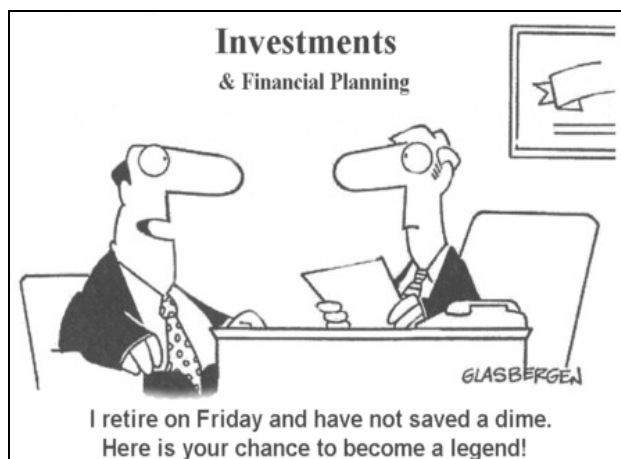
Index (August 23, 2000)	Value	%chg/3mo	%chg/1yr
TSE 300 Index	11100	+ 21 %	+ 54 %
S&P 500 Index	1505	+ 7 %	+ 10 %
Dow Jones Industrial Avg.	11144	+ 6 %	- 1 %
NASDAQ Composite Index	4011	+ 22 %	+ 45 %

If you were to look at the performance of the TSE 300 you would form the opinion that the Canadian stock market has done extremely well. The reality though is that only a few stocks have actually done well and one stock in particular has done very well, Nortel Networks. First let me say that I would not buy Nortel at current prices. I am a value investor and because of my principles I feel there is little value in Nortel. Nortel trades at a market capitalization (meaning if you wanted to buy all of the shares and own the company) of

\$366 billion (3 billion shares outstanding times \$122 per share). Nortel last year had revenue of \$33 billion and no profits, meaning it is trading at 11 times twelve months trailing revenue ( $\$366/\$33 = 12X$ ). Most companies normally trade at a fraction of revenue and trade at a multiple of 6X (6 times) to 24X net earnings depending on the growth rate of the company. Why is this the case?



As an example, if a company has \$100 million in revenue it usually will have net after-tax earnings of \$4 to \$15 million depending on profit margins. If you wanted to own this company, you would want to get your money back within a certain number of years. If it made \$15 million in net earnings each year (very high margin) and you paid \$90 million to buy the company you would get your money back in 6 years. This would be a reasonable deal and you may buy the company for \$90 million (almost 1X revenue). Nortel currently trades at 11X revenue and assuming a similar margin of 15% (which is extremely generous), 15% of \$32 billion revenue is \$5 billion in profits which potentially may occur (Nortel currently has no profits but in a best-case scenario this is what may unfold). Now let's use an extremely high multiple of earnings, say 30X (which is normally only used if the company grows at 30% a year consistently). 30 times \$5 billion is \$150 billion, meaning in a best-case scenario the maximum price you would pay to buy Nortel is \$150 billion and it would take you around 13 years to get your money back (not exactly a good deal). At current prices Nortel is trading at double what one would pay in a best-case scenario, and you would have to wait around 26 years to get your money back (imagine if a best-case scenario did not unfold and Nortel did not report good earnings...). So why is Nortel so expensive then? Well, for a few reasons; 1) technology stocks are the fad and people have been buying the leaders, 2) investors have not been looking at fundamentals (earnings, debt, assets, etc.), and most important 3) Nortel makes up a large percent of the TSE 300 index and as a result many mutual funds have had to buy Nortel based



on the percent of the TSE that it composes. Reason number three brings up a worrisome point. You see the TSE 300 index assigns weightings to stocks that compose the index based on its market capitalization. As a company's market capitalization grows faster than other stocks on the index the TSE assigns higher weightings to that stock. Nortel has gone so high that it now has a 35% weighting of the TSE 300 Index. As it goes higher in price its weighting grows as well. Mutual funds that mimic the index also have to have a similar weighting of Nortel in their portfolio. Thus they continue buying it, which drives the price higher, which drives the weighting higher, and so on. Eventually though this "house of cards" will fall. The TSE should never have let the weighting of Nortel grow so high to 35% but then they never thought the stock would have continued going up. They know that eventually they are going to have to limit the weighting of Nortel to 15%, but then they also know that this will cause all of the funds out there to have to begin selling Nortel to reduce their exposure to a similar level as

well. They would rather wait for Nortel to go down on its own because if they reduced the weighting to 15% tomorrow the stock potentially could drop in price as funds rapidly reduced their exposure. They do not want to be responsible for this but eventually they know they will have to. I have no sympathy for the TSE's dilemma because they should never have let the weighting go beyond 15% in the first place. The TSE 300 index is no longer an index and if they do not do this soon I will stop referring to the Canadian market as the TSE 300 index and use something else. It is not that I do not like Nortel, it is just that I want people to be aware of the risks of owning the stock at current prices and that the TSE 300 index is no longer representative of the Canadian market!

Where are the overall markets going to go from here? Well currently I believe that the markets are on a final rally that is likely to end within a few weeks. The markets have limited upside and substantial downside, as a result I have increased my weightings of cash. I still am holding value-oriented stocks as I feel they have more upside but this does not apply to the overall market. I am negative on technology, biotech, and wireless stocks and feel investors who want to make money will have to focus on fundamentals in the years to come.

Index	Value	chg/3mo	chg/1yr
London FTSE 100 Index	6566	+ 7 %	- 3 %
German DAX Index	7232	+ 6 %	+ 15 %
France CAC 40	6501	+ 8 %	+ 22 %
Brazil Stock Index	17450	+ 23 %	+ 77 %
Mexico Bolsa Index	6367	+ 9 %	+ 21 %
Australia ASX Index	3322	+ 12 %	+ 1 %
Japan Nikkei 225 Index	16436	+ 2 %	- 6 %
Hong Kong Hang Seng Index	17427	+ 25 %	+ 27 %

## World Markets

I feel that stock markets internationally are also expensive and that the downside risk is larger than the potential for gain. The markets that I feel are overvalued the most include Hong Kong and South America. Europe is fairly valued as is Japan which recently has dropped substantially from its highs reached in early April. I am not finding any of the global markets particularly attractive at the moment.

## Commodity Markets

Crude oil continues to trade at record high prices as the United States pressures OPEC to increase production. It is no wonder why as currently the US has the lowest level of crude oil reserves (280 million barrels), a 24-year low. Normally US refiners would be buying oil now to stock up for the Winter season which will be approaching in a few months. However the refiners have been deferring purchases hoping that the price of oil would drop so they could buy the oil cheaper. This has not happened and as a result they will soon have to start buying oil whether they like it or not. This is the main reason why the price of oil has remained high. OPEC however, has stated that if the price of oil remains above \$28 a barrel for 20 consecutive days they will increase production to keep it in a range of \$22 - \$28. It will be interesting to see if and how much they boost production on the September 10<sup>th</sup> meeting coming up. Overall I feel oil prices will remain strong leading to Winter. Once there are signs the US reserves are beginning to recover the price of oil will weaken. However if globally we get a very cold Winter you could see an even bigger squeeze on the price of oil although it is likely to be short-term as OPEC would eventually increase production.

Commodity	Price US\$
Crude Oil	\$32.7
Gold	\$274
CRB Index	222

The price of gold continues to remain weak. I have not seen reason for it to go higher other than the fact that gold production is decreasing due to the prolonged low price environment. Eventually it will strengthen and the current trading pattern indicates that this is likely soon.

## Fixed Income

Following is a list of bonds and debentures that I feel offer a high yield and are "A" rated quality:

- Farm Credit, April 2001, 5.55%
- GMAC, July 2002, 6.15%
- Bank of Nova Scotia, March 2003, 6%
- National Bank, June 2003, 6.16%
- GMAC, July 2004, 6.4%
- Toronto Dominion, April 2005, 6.28%
- US pay bonds: Ford, October 2001, 6.64%
- GMAC, November 2003, 7.1%

## Tax, Estate & Investing News

This is a new section that I plan on using to inform people about new issues or ways of making or saving money. This quarter I will be discussing the new capital gains tax rules and the merits of using a mortgage broker.

### 2000 Budget Reduces Tax on Capital Gains

This is already old news, but the February 28, 2000 federal budget reduced the capital gains rate from 75% to 66.67% for capital gains realized after February 27, 2000. The result is capital gains are now taxed at approximately the same rate as Canadian dividends. However, as the lower rate only became effective on February 28, you and your clients may have to deal with two different inclusion rates for the 2000 taxation year. Therefore, it's important to keep track of gains and losses realized on or before February 27 and on or after February 28 separately.

Here are the three situations your clients may face, and how capital gains should be reported in each case.

#### ***1. Net gains or net losses in only one period (either pre- or post-budget)***

The appropriate rate in effect at the time of the transaction(s) will be applied.

#### ***2. Net gains or net losses in both periods***

The 75 per cent inclusion rate will be applied to the net gains (losses) realized in the pre-budget period and the 66.67 per cent inclusion rate will be applied to the net gains (losses) realized in the post-budget period.

### 3. Net gain in one period and net loss in the other

Calculate the net gains or losses realized in each period and then compare the two periods. The rate for the period with the greater amount realized will be applied to the net gains or losses for the entire year.

#### **Example**

Lori redeemed Fund A on February 1, 2000, for a loss of \$500. She then redeemed Fund B on August 1, 2000, for a gain of \$2,000. Lori's pre-budget loss is \$500 while her post-budget gain is \$2,000. Since the post-budget amount is higher, the post-budget rate of 66.67 per cent will be used. After netting the two amounts, a net gain of \$1,500 remains for the year. This is multiplied by the post-budget inclusion rate of 66.67 for a taxable capital gain of \$1,000 in the 2000 tax year.

*The above material is general tax information. One should seek individual tax advice specific to their needs, as their situation may be different.*

### **Benefits of a Mortgage Broker**

Recently I purchased a property and went through the whole process of transferring real estate. Knowing the importance of advice I sought out the professional services of a real estate agent, mortgage broker, and lawyer / notary to handle the property title transfer. Not many people know what mortgage brokers do or how they are compensated so they do not use their services as a result. The greatest benefit of using a mortgage broker is that they act as an agent for you and obtain the lowest rate for your mortgage. They can do much more though, so I will explain how the process works:

First the mortgage broker (agent) will have to obtain financial information about you (your income for the last few years, assets, liabilities, employment status, etc.). The reason for this is that the agent will need to determine the level of risk the mortgage you are requesting is relative to the down payment, your credit rating, and your income level. Once the mortgage broker obtains your financial background and meets with you to determine the terms of the mortgage you are looking for, he/she will then shop around with financial institutions to obtain the best mortgage. Mortgage brokers will deal with banks, trust companies, credit unions, life insurance companies, and mortgage corporations when negotiating a mortgage for you. Why would a bank be willing to issue a mortgage from outside their branch offices? Well, the mortgage market is very competitive these days and if a bank can issue mortgages without the cost of advertising or paying someone to process applications in house, then they are willing to pay a small fee to obtain the mortgage brokers business. A mortgage broker's compensation comes from the financial institution paying a commission to the broker for submitting all completed documents from a client on terms the financial institution is willing to accept. Rates that mortgage brokers negotiate are typically the lowest providing the client has good credit. If the client has poor credit and is having difficulty in obtaining a mortgage the mortgage broker may also be able to arrange a mortgage when banks previously turned them down. In addition the broker should advise you on what is the most attractive options for the mortgage (closed/open), prepayment terms, avoiding property transfer tax, and explain the whole process. I had the pleasure of dealing with a very professional broker who provided a high level of service. If you are interested in speaking with him I have left his number below.

Todd Hickling, Ambro & Associates Mortgage Consultants Ltd., Cell. (604) 803-9248, Fax. (604) 899-0362

I also found a very reasonably priced agent to handle property transfer who was also very professional.

I have enclosed an internet link where more information can be obtained ([www.canadamortgage.com/](http://www.canadamortgage.com/)).

### **Focus Stocks:**

**Stock ideas are omitted on web site version...**

**Request newsletter via email in order to receive full version...**



Note: Currently I am researching and recommending other stocks that I have found attractive. I have not mentioned them in this newsletter but may be covering them in future issues. If you are interested in some of these ideas please call me at 643-0178.



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