REVIEW & COMMENTARY
2ND QUARTER 2007

Bye, bye BCE

It seemed quite ironic (at least to us) that one of Canada's oldest publicly traded companies- BCE Inc- announced the day before Canada Day that it had agreed to be taken over by Teachers Pension Plan and a number of other partners. While Canada Day celebrates a historical new beginning in the life of Canada, this too may be an opportunity for a new beginning of BCE. With new ownership and a new attitude geared toward little else than improving its competitive position and profitability, BCE will attempt to forge out a new identity and which possibly might restore it to some sense of former glory. However, they will do it without many long standing shareholders as a private company.

One long standing shareholder who if alive today would still be holding his shares would have been Sim Stodgell, to whom our firm owes so much (including its name). Sim was a long term investor. Sim held BCE throughout his life as a mainstay in his portfolio and given that he passed away when he was over 103 years old, he was the epitome of a long term investor. At one time he regretted selling an investment after 15 months stating that he "wasn't a trader". He maintained BCE since it had enjoyed a dominant position in the telecommunications industry and had a disciplined devotion to shareholders by increasing dividends regularly. After cutting his financial teeth in the late 1920's and 1930's he had been convinced that a sure fire way to invest successfully was to invest in solid companies that paid a dividend. This will allow shareholders to weather most financial storms and Sim not only survived the storms of 1929 but also of 1987. Sim left us in 1998, about the same time BCE was still a primary holding for so many investors, and the same time Stodgell Investment Management Ltd. became an independent business. But in the past 10 years, BCE lost its preeminence- it no longer dominated the marketplace and its dividend had not been increased with the same regularity of the previous decades. If he were alive today, he would react to the news of the board's capitulation with mixed feelings. On one hand he would be disappointed: as a long time portfolio holding he would begrudge the idea of it being taken away and paying capital gains tax. Given his original cost and the income provided over the decades, it would be hard to replace. On the other hand, we suppose, he might suggest that it was an inevitable outcome of a management that had been unsuccessful in navigating the competitive waters of the industry.

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Another potential source of contention he might have, as we do, is the inordinate amount of compensation the executives of the company will receive once the takeover is complete. Michael Sabia, BCE CEO, was granted 450,000 options this past March at a price of just over $30. Fourteen others were granted over 100,000 options each at the same time. Ontario Teachers Pension et al, will pay them $42.75 within the next twelve months, yet the stock rarely traded over $32 for the past 5 years. That doesn’t include anything received prior to those years. Never against executives being properly compensated for creating value, Sim would not support the pending millions of dollars in compensation that BCE executives and the board members will receive because of this takeover. He, and certainly we, certainly considered it undeserved given that they did not create it.

Of course, on the grand scale of investing in the world, this takeover was of marginal interest. The most recent quarter started well for equities, May was particularly strong. June started out well only to give a good percentage of the gains back. Some of this downturn was caused by concerns over the future direction of interest rates as many investors considered the likelihood of rates going up by year end greater than those who did not. This was quite different than at the beginning of the year. The fear of higher interest rates took substantial air out of the housing resale market given that many real estate investors were already feeling a significant financial pinch due to their adjustable mortgage rates being adjusted in the wrong direction- i.e. upward.

But in typical fashion, the markets reacted quickly. Interest rates moved up quickly hitting equities quite hard, particularly interest sensitive stocks, in June. Moreover, all the private equity firms that had taken advantage of low interest rates to make their purchases were thought to be re-considering their spending sprees depressing equity values even further. However, it is important to remember that private equity firms are flush with cash but they don’t get paid to hold it- so while rates have increased, it won’t dampen their appetite. They might become a bit more discriminate.

In terms of interest rates, we had predicted in our year-end market review last year that interest rates in 2007 would end up higher than where they started at the beginning of the year. So far we appear to be on track. But the quick adjustment in rates recently was typical of many recent market corrections- it was fast and furious. As in the past, this reaction was over done- rates have somewhat moderated since. One important transition from this bond market correction was that the yield curve went from marginally inverted to positive. As we have spoken before, inverted curves are generally not positive while positively sloped yield curves do portend positive economic activity (a positively sloped yield curve simply means that interest rates in the short term are lower than in the long term). A positively sloped yield curve bodes better economic times. As long as inflation is contained, this is good news for stocks – growth often means increased margins and profits. Higher profits mean higher dividends. This is good news. And while we may have lost BCE, it isn’t the first or last we will lose- Alcan has a new bid which looks definitive. And though markets are trading at highs, the basic fundamentals suggest that it will continue to do so. But as we have said before and continue to support- volatility will remain high which will benefit those who can remain patient. We are and so was Sim.

Stodgell Investment Management Ltd.