

FRIEDBERG  
MERCANTILE  
GROUP

**Second Quarter  
Report  
1998**

FRIEDBERG  
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Dear Investors,

As we end the second quarter, we have become even more confident of the correctness of our present investment posture.

I trust you will gain, in the inside pages, an insight - and a flavor - into the views that drive this investment posture and how we hope to capitalize on some of the surprises that lay ahead of us.

Albert D. Friedberg



## **FOREIGN BONDS**

FRIEDBERG FOREIGN BOND FUND

FRIEDBERG TOTAL RETURN FIXED INCOME FUND LTD.

FRIEDBERG TOTAL RETURN FIXED INCOME LP

The quarter produced a mildly negative return, averaging -1.5%. Returns were positive for Canadian-based investors, however, to the tune of 3.2%, because of the falling Canadian dollar.

Our feeling of disappointment can be ameliorated only by the knowledge that (1) we have already paid the costs of restructuring the portfolio, in line with our previous quarterly comments (which we'll discuss in more detail later on), and (2) we have built a portfolio that should generate annual returns of better than 7%, even under relatively adverse conditions.

A modest to fair exposure to New Zealand dollar assets (between 26% and 30%) continued to weigh negatively on our overall results. New Zealand's currency fell an extraordinary 6.17% for the quarter. All of our convertible New Zealand securities were marked down, the Kiwi Income Property by 7.4%, St. Lukes by 8.9% and Trans Tasman by 8.1%. At quarter-end, these securities provided yields to maturity of 11.56%, 11.9% and 22.13%, respectively.

Leverage for these property trusts is modest and interest coverage is quite ample, particularly for the first two named debentures. The mandatory conversion into shares at maturity assures that redemption will not cause any liquidity problems. The real estate market in New Zealand has been sold down on fears that the South East Asian crisis will produce many vacancies. This is highly unlikely, as there has been very little new construction in recent years. In fact, the market is still struggling with uneconomic rental rates for office buildings in the central business district. Trading conditions for the retail sector, especially the well positioned retail malls (an important part of Kiwi and St. Lukes portfolio), remain good and will no doubt benefit from the recently enacted tax cuts.

As mentioned earlier, the fall in the New Zealand currency had a negative impact on our portfolio. Part of the pain was overcome by occasional hedging forays, although clearly not the entire move. We were surprised by the extent of the decline and the extreme negative sentiment engendered by the much misunderstood current account deficit.

The decline of the New Zealand dollar is but another aspect of the extraordinarily strong US dollar, which has risen in recent months to multi-year highs. As global bond fund managers, we are continuously on the lookout for attractive total return opportunities (remember, total return is a combination of yields, capital gains/losses and currency gains/losses) in assets denominated in all the actively traded currencies of the world. It is only through this type of diversification that we are able to produce above-average risk-adjusted returns in the long run. At times, it's best to remain 100% in US dollars - and today appears to be one of

those times - but many more times the opposite is true.

To appreciate fully the current portfolio, it is important that you understand the philosophy that drives it. As stated in our previous report (and in various other publications), we believe that we are about to enter an extremely difficult period for the global economy, comparable in some ways to the experience of the thirties. This coming global contraction, begun at the edges of the world economy (South East Asia) a little over one year ago, has already affected 35% to 40% of the world's Gross National Product. Inevitably, it will engulf the entire industrialized world - not because it is an infectious, contagious disease, but because the problems all stem from a common cause: a decade-long recklessly easy monetary policy superimposed on bad economic decisions that lift moral hazard to ever higher heights. Economic agents are led, through mistaken signals, to make uneconomic and unproductive investment allocations all over the globe, leaving behind a tragic trail of bad investments. These bad investments need to be liquidated. The liquidation brings depression, in Japan, in Korea, in Indonesia, in Russia and finally even in North America and Europe.

Unlike the situation in the thirties, the present liquidation will take place in the context of a fiat money regime, not a gold standard, and thus outright deflation will be avoided. Instead, depression and inflation will exist side by side. It will be difficult to make money because this combination has few if any analogues. Our best guess is that the US dollar will remain strong well into the global contraction, until it is overcome by a gigantic trade deficit. Consumer-price inflation in the US will climb out of its comfortable range of 2% to 2.5%, moving into a 3% to 4% range and making life very uncomfortable for the Fed. Interest rates will rise, profit margins will collapse, and emerging countries will default on their bonds (now much more widely held than in the mid-eighties) as they find themselves unable to renegotiate and "restructure" as they did with bank debt.

In this scenario, the ideal portfolio is denominated primarily in US dollars, is studded with first-class sovereign risk, has a short duration, and contains cheap bets on inflation and on an expected bear market in US stocks. Where credit risk is taken, we insist on substantial spreads above risk-free benchmarks and on very short-term maturities so that maximum flexibility is retained. Needless to say, in such cases exposure is contained at less than 5% of total portfolio.

Outstanding examples are inflation-linked US Treasury and Government of Canada bonds (the latter hedged back into US dollars), which represent approximately 34% of our average portfolio; US dollar-denominated Argentinian Treasury bills due in mid-October; various short-term US dollar-denominated notes paying Libor plus 450-600 basis points and issued by Aerolineas Argentinas and Korea Electric Power, among others; a 95% principal-protected derivative instrument issued by a first-rate German Bank and paying a modest interest rate, which is due in 15 months but contains a number of S&P 500 put options; and the aforementioned New Zealand convertible

securities. It is perhaps worth noting that the average credit rating of rated issues in our portfolios is AA+ while the average credit rating of non-rated issues is approximately BBB+. The overall credit rating is A, the highest in our management history.

For the balance of the year, we expect returns to catch up significantly. On a risk-adjusted basis, our results should exceed nominal Treasury obligations and help us meet our long-term expectation of capital preservation along with a fair return.

### **CURRENCY PROGRAM**

FRIEDBERG CURRENCY FUND  
FRIEDBERG CURRENCY FUND LTD.  
FRIEDBERG FOREX LP

The Currency Program turned in another good performance for the quarter, up on average approximately 9.5%. Year over year the numbers cluster around a 38% gain, a respectable showing by any account.

In this business, persistence pays - as long as you are able to protect the downside. We finally managed to make a profit on the short side of the Yen, not allowing bygones to spook our wits. And to prove that the Yen operation was not merely luck, we plunged back on the short side of the Brazilian Real, unrepentant and unbowed, despite having been literally clobbered last quarter.

On fundamentals, the picture is grim and getting grimmer by the day. The Cardoso government is hanging by a thread. Public debt, bearing real interest rates of more than 16%, is soaring. Reform of the fiscal black hole, Social Security, is barely proceeding, as it is booby trapped by a coalition of corrupt and indifferent lawmakers and a welter of vested interests. All eyes are on July 29, the day on which Telebras and its mini-bells will be privatized. We predict that a successful privatization, that is, with prices above the minimums for the ensemble of companies, paid by foreign buyers and consortia, will buy Brazil a few more months, perhaps until November. In this case, we may have to run for the hills, with our tail tucked between our legs. A poor reception, on the other hand, will unleash a massive selling of Reals and force a float within a few weeks. While all eyes are now on Ronaldo and the Copa, all eyes better be on Telebras. The fate of the nation depends on it.

Trading opportunities continue to exist in a number of currencies, in particular those of emerging economies. We should keep in mind, though, that the cost of conducting these type of trades is far greater than those incurred in trading the major currencies. This point was brought home last quarter in our discussion on slippage.

Another important consideration is the cost of carry incurred on selling exotic

currencies that are under pressure to devalue; at times, it can run to as much as 30% to 40% per annum. As a result, failing to time a trade properly could have a devastating effect on our equity. Fortunately, opportunities are beginning to become visible over the horizon, if only barely, to trade the "majors" - among them, the heretofore mighty US dollar.

## **DIVERSIFIED TRADING PROGRAM**

FRIEDBERG DIVERSIFIED FUND

FRIEDBERG DIVERSIFIED POOL

Once again the Diversified Trading Program encountered a losing quarter. One winning trade and three losing ones produced a net draw-down of approximately 14%.

Our most substantial loss was incurred in a bearish bet on the US equity market via S&P 500 futures. Losses on the completed trade ran to the equivalent of almost 9% of initial equity. What prompted us to initiate this position was the deteriorating technical condition of the market coming against the background of historically excessive valuation levels, a collapsing corporate profit outlook and the strong probability that a significant global contraction was in the making. In fact, breadth figures and the ratio of new highs to new lows have been denoting a narrowing and increasingly belabored advance, a sure prelude to a bear market. And yet, the power of the generals has continued unabated, providing further impetus to the aging bull market.

We remain convinced that it is no longer a question of "if" but rather of "when." Perhaps the coup de grâce will come when monetary policy in the US will need to address accelerating US inflation led by the booming services sector and masked only temporarily by the manufacturing/tradables sector. We shall return to this trade, without a doubt.

A similarly compelling case can be made for selling JGBs, the Japanese 10-year government bond. There was no possible reason to countenance 10-year yields in the vicinity of 1.55% unless, of course, one believed that Japan would undergo a 10-year deflation. This was especially true in the face of a huge increase in Bank of Japan assets, which almost guaranteed a sharp pickup in inflation for the near future. Or so we thought at the end of last quarter.

Less than one week into the new quarter, we were forced to revise our opinion: The inflationary implications of the Bank of Japan's monetary shenanigans were explained away by a Bank official in a letter addressed to The Financial Times of London (and later confirmed in a private correspondence to us). Effectively, the monetary base was not greatly affected and, thus, the money supply was not about to explode. We promptly covered the position and accepted a modest loss (equal to a little more than 3% of the starting equity). Since then, yields have

continued to fall, reaching all-time historic lows of 1.18%. Here, too, we believe that the bubble will inevitably burst; we remain attentive to re-enter the short side of this market.

Copper, traded from the short side, yielded the sole gain for the quarter but made us realize the difficulties in establishing meaningful positions in run-of-the-mill commodities. Slippage costs loom very large on trades greater than 600 to 800 contracts. Where possible, it is best to stick to financial futures and a very few, select group of commodities that includes gold and crude oil, but excludes such erstwhile favorites as silver, cocoa, sugar and most grain futures. This may be one of the principal reasons why we were unable to capitalize on some of the more worthwhile trends in recent months. Nevertheless, the wide choice of actively traded financial futures available makes us reasonably confident that, in coming months, we will be able to hitch on to some dramatic trends that are certain to take place. These need to conform, of course, to our view of the world if we are to make confident and aggressive bets.

### **FRIEDBERG GLOBAL OPPORTUNITIES FUND LTD.**

The Global Opportunities Fund combines the Diversified Trading Program with a global securities program. As such, the following remarks should be read along with our earlier comments on the Diversified Trading Program.

In happy contrast to what occurred last quarter, our global securities portfolio managed to eke out a 3.6% gain for the current period. This served to offset somewhat the large losses incurred in the Diversified Trading section. Coming into the quarter, we were short 15 Japanese bank stocks - financial institutions that we felt would eventually be closed by the authorities because of insolvency. With one exception, the list included no money centre banks. We suspected that the authorities would make every conceivable effort to keep them alive. In fact, recent talk of closing failing banks inevitably benefited the money centre lenders for precisely the reason that they would be saved harmless and would almost certainly gain market share (and despite the fact that they too are "failing").

Against these short positions we purchased a handful of construction companies and a number of Nikkei futures contracts with the intention to hedge our short exposure in the event that the Bank of Japan pursued an aggressive reflation (see earlier discussion of the Bank of Japan incident). As it turned out, the full hedge became unnecessary and the Nikkei futures were covered. In its stead, we began purchasing an assorted group of companies, with solid balance sheets and/or good profitability, that we believed would benefit from the relatively cheap Yen and/or from an accelerated economic recovery. By the end of the quarter, this long position equaled, in dollar value, only a modest 16.9% of the short position.

Over time, we plan to increase our long exposure to solid, well managed Japanese companies. We believe that sooner or later Japan will find a way out of its predicament. That, of course, will not happen until the government faces reality and bites the bullet on a large segment of its banking industry. Failing official action, a run on the banks will do the trick. One way or the other, Japan will "solve" the banking problem. We look forward to covering the short position at a fraction of its present market value.

### **EQUITY HEDGE PROGRAM**

FRIEDBERG EQUITY HEDGE FUND LTD.

FRIEDBERG TORONTO TRUST EQUITY-HEDGE FUND LTD.

This past quarter turned in a satisfactory performance on all accounts.

From a return point of view, the older and more fully invested fund, Friedberg Equity Hedge Fund Ltd., was up 4.8% for the period. Importantly, the monthly variations showed no correlation with those of the stock market as represented by the S&P 500. In May, our hedge fund was up 4.52% while the S&P 500 was actually down 1.88%; in June, our fund was down 0.7% while the market was up 3.94% (in April both were up fractionally). In this respect, the equity hedge program has lived up to its stated objective: above-average returns within the context of market neutrality.

Some interesting statistics: Fourteen out of 19 short positions (closed and still open) were profitable during the quarter, while only 10 out of 28 long positions were in the plus, a strange reversal from last quarter. Our three most profitable short positions, Adaptec, Union Pacific Resources and Newbridge Network, showed returns on cost of 27.07%, 26.44% and 22.63% respectively. Our three most profitable long positions, Intuit, AMR, and A.O Smith, showed gains of 21.89%, 16.28% and 15.5%. Significantly, our three worst performers on the long side were biotechnology issues: Dusa Pharmaceutical, -56.05%; Celtrix Pharmaceutical, -26.67 (one of the two largest winners last quarter); and Cytel Corp., -23.09%. None of these companies are as yet profitable but they still hold the promise of dramatic breakthroughs, and profits, in the months and years ahead.

Other noteworthy statistics: To maintain an even keel, we were forced to continue emphasizing longs over shorts. At its highest point, we were long 62.49% and short 37.51%, based on month-end figures. By the end of the quarter, the ratio had decreased somewhat, with longs standing at 56.76% and shorts at 43.24%. This in no way implies that we had a long bias during the quarter. It simply means that the shorts were more volatile relative to the market than our longs (in industry lingo, the shorts had a higher beta). Overall leverage increased during the quarter, moving up from 2.36 times to 2.19 times at the end of April, 2.35 times at the end of May and 2.51 times at the end of June.

The leverage ratio is a function of opportunities, margin availability and neutralizing operations, if the need arises.

In concluding, we should point out that one-year returns have exceeded risk-free rates by only 100 basis points. In our opinion, this meagre performance may be due to the large inflows relative to the size of the portfolio in the initial months and the considerable slippage incurred in building up positions (as discussed in our communication to shareholders at that opportune moment).

We are gratified that this initiation phase is past (although it is still affecting our newer Toronto Trust Equity Hedge Fund). As we pointed out last quarter, the equity hedge fund's proper benchmark is not the S&P 500 but a T-bill rate plus some added measure for volatility of returns/risk. This added measure should be somewhere in the area of 300 to 500 basis points. That is to say, we would not be satisfied earning less than 300-500 basis points more than T-bill rates. Our expectations, that is, our wishes, on the other hand, are considerably more ambitious. In this regard, we hope not to disappoint you and ourselves.

## **NEW ZEALAND**

FRIEDBERG NEW ZEALAND FUND LTD.

NEW ZEALAND EQUITIES FUND

FCMI KIWI EQUITIES INVESTORS

Bargains galore! The deadly combination of falling equity prices and a falling currency has left New Zealand stock prices at bargain-basement levels, particularly for foreign buyers. From the October highs, the New Zealand 40 index fell 25.4% in local currency and 38.3 % in US dollar terms. Over the past quarter, the index fell an astonishing 19.45% in US dollar terms. Our own performance closely approximated these results, mirroring in most cases the slightly better performance of the New Zealand Small Cap index.

While there is no denying that the South East Asian economic debacle has had, and will continue to have, an impact on the New Zealand economy, the markets have seemingly discounted a permanent depression. A look at valuations should convince any value-oriented investor of the validity of this opinion. As an example, the median reading for our large sample of New Zealand-listed shares shows the following ratios: price to sales of 0.86; price to earnings of 9; price to cash flow of 6.5; price to net tangible assets (a far more conservative measure than the more commonly known book value, as it eliminates such items as goodwill) of barely 1; and total debt to market capitalization of 37%. Gross dividend yield (the equivalent to an after-tax yield) for the New Zealand 40 index was a juicy 7.99%. These readings compare favorably with comparable US valuations of the early eighties, before the market lifted off into the stratosphere.

Our own 10 largest holdings, shown below, exhibited even more extraordinary valuations:

#### 10 LARGEST HOLDINGS IN THE FUND

	Price As AT 30/06/98	Price /Sales	Price /Earnings	Price /Cash flow	Price /NTA	Gross	Dividend Yield %
Kiwi Income Property	93	N.A.*	10.20	11.0	0.85		10.41
St Lukes	142	N.A.*	6.60	13.1	1.07		9.84
Fisher & Paykel	490	0.7	15.50	7.2	1.46		5.51
Trans Tasman Prop.	43	N.A.*	23.50	12.0	0.45		10.47
PDL Holdings	485	0.2	4.80	3.1	0.83		12.37
DB Group	255	0.4	8.60	4.7	1.12		8.82
Hall Glasson	131	0.5	6.80	3.9	2.30		21.76
LWR Industries	96	0.3	5.40	Neg.	0.68		23.44
Sanford	293	1.0	16.60	11.0	1.24		5.63
Air NZ "A"	183	0.3	7.70	4.5	0.66		16.39

\*N.A. (Not applicable for property trust)

The external shock has caused Gross Domestic Product to slow down in recent months and growth is expected to come in below 2%. Nevertheless, government finances continue healthy, as the country moves into its fifth consecutive year of fiscal surplus. A scheduled NZ\$ 1.2 billion tax cut takes effect this July 1 - the second one promised by the present coalition, accompanied by the prime minister's unusual exhortation in this age of consumerism to spend as well as to save: "New Zealanders who save are not only helping themselves, they are helping their country," the PM said, adding that "if New Zealanders save more, we borrow less from overseas. That reduces the pressure on the current account deficit."

This is a far cry from the demands on, for example, the Japanese to cut taxes and jump start the economy ad hoc and desperate measures that do little more than pile up more debt on an already overburdened economy.

The current account deficit, running between 7% and 8% of GDP, continues to trouble economists and investors. This particular forum as well as space considerations do not allow us to explain why the deficit, at this time, is of no concern to us. We refer interested parties to an excellent piece penned by three economists of the Reserve Bank of New Zealand: "The current account balance: an analysis of the issues" by Sean Collins, Francisco Nadal de Simone and David Hargreaves (available on request).

Suffice it to say that the floating-rate regime will protect the country from importing depression while New Zealand's robust banking system will allow the Reserve Bank to conduct an unfettered and rational monetary policy. Real assets - shares included - have become extremely attractive as a result of the pronounced 17% fall in the trade-weighted value of the currency. It is worthwhile to point out that the expected "adjustment" will come not only by way of a larger trade surplus but by continued capital inflows (primarily of the equity type rather than debt), attracted by the relative cheapness of these assets.

If our readers are rational, as we believe they are, they ought to consider increasing exposure to the New Zealand equity market while reducing exposure to the wildly overvalued North American and European markets.

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