



WARM MILK AND SWEET DREAMS

Everybody wants a good night's sleep. But there is a lot of scary noise out there. Middle East turmoil, the Japanese nuclear crisis, European debt problems, a budget impasse in the U.S. congress, S&P warning of a downgrade of U.S. government debt, debasing of the U.S. dollar, falling U.S. house prices, high oil and gasoline prices, a record gold price, higher inflation, a potential left wing coalition government in Canada and Donald Trump as U.S. President. Understandably, our clients, and individual investors generally, are fretting, and it's keeping them awake at night. It's natural. Confidence levels have remained low since the debacle of '08, and risk aversion has become paramount. Surveys show that individual investors believe the odds of a one-third stock market drop is over 50% in any given year where true odds are closer to 2%. Investors today are too fearful. We believe our current portfolio and our investment process should give our clients the solace they need.

The perception, even of some long-standing clients, is that we take on higher risk. But in fact, we have always sought, and seek, securities with below-average risk characteristics. A few factors may have created a misperception: 9 years of outperformance through late 2007 where our equity composites compounded at more than 27% per annum, such high returns being perceived as having had to be accompanied by high risk; portfolio holdings whose names are unfamiliar, making for uncertainty—fear of the unknown; and, the regrettable outsized declines of our holdings during the Panic of '08, a rare phenomenon, but which investors nonetheless tend to automatically assume as having derived from higher risk.

Looking Down First

From our standpoint, our portfolio holdings have below-average risk. We always look down first, and today, even in our downside risk analysis, most of our holdings exhibit low-case valuations that are still higher than current share prices. Accordingly, we think the likelihood of permanent impairment in our securities is minimal, if any at all, inasmuch as our downside analysis forecasts higher prices. Upside. And our anticipated potential rates of return to the base-case appraisals of our holdings are well above average. Substantial upside. A win win.

We suppose it's human nature to link risk with reward—to think they're positively correlated. It's engrained in us. Like a lottery ticket—infinitesimal odds of winning but a huge possible windfall. High risk, high reward. Speculating. Gambling. Believe it or not, they even teach this at business school—the Capital Asset Pricing Model, for which Nobel prizes were awarded, based on the concept of the positive correlation between risk and reward.

Well, we don't believe investing should be approached using this paradigm. Sure, you can occasionally make an outsized return by taking on high risk, but you can also suffer permanent losses—lottery-style binary outcomes—all or nothing. However, with securities, if you do enough basic research, and uncover situations possessing the desired optimal metrics, you *can* have the best of both worlds—lower risk and higher reward. Bargains. Just like shopping—searching for brand name products at reduced prices—lining up at Costco or sifting through the bins at T.J. Maxx/Winners for bargains. Unfortunately, most don't approach their stock or bond buying with this 'bargain' mentality. As investment managers, our job is to turn over rocks, to sift through investment ideas until we find ones where risk of permanent loss is low (below average operational, financial and valuation risks)—where the stock is 'on sale,' a genuine bargain. Sometimes, as now, you don't even have to look under rocks—there are great ideas staring investors in the face. Big-cap orphans. Unlike 2007 when these big-cap names were overly popular and fully valued. Why is that the case? Well, markets are frequently not rational, and, more so, individual stocks are often mispriced irrationally—unwanted from being misunderstood, unjustifiably shunned or just unknown. In our lingo it's called 'inefficient.' It's what you pay us to look for—to find undervalued, inefficiently mispriced investments. Low enough to minimize the risk and low enough to enjoy an enhanced reward. A win win.

Our Downside Is Upside

In past quarterly letters and in discussions with clients we regularly indicate the potential upside from our portfolio holdings. But it seems we have not adequately articulated the protection evident from our downside analysis—that is, the value of each security should our base-case expectation not pan out.

Importantly, again, even in our downside analysis for our equities today we're actually still seeing upside potential. Our favourite current example is Dell which trades as if it will have negative growth in perpetuity—based on reverse-engineering the expected discounted cash flow. But, guess what? Dell *is* growing and has reported *record* earnings. Even if Dell's trailing 12-month free cash flow were to remain flat forever, a low likelihood but nonetheless our downside risk analysis, Dell would still be worth \$18 today, more than \$2 above its current share price. Even the downside has upside. Bottom line, the likelihood of permanent impairment is minimal if even in our downside analysis we anticipate a price higher than the current price. Upside.

Sleep Factor

We're now sleeping better than ever. Regrettably though, like most individual investors today, some of our clients are nervous—even if the portfolio has never had so little downside risk (i.e., permanent threats) with such meaningful upside potential. Forget warm milk to calm your nerves, just reread our quarterly letter each night—if only to bore you to sleep. We can't say it more forcefully, that the downside protection and upside potential from this safe portfolio should lessen any anxiety, allow a good night's sleep, and even sweet dreams.

Our long-term record since inception, despite the outsized drawdown in '08, and our outperformance since the Panic, should provide comfort too. Most of the time we're doing it right—70% of our quarters for our long/short equity composite have been positive. Similarly, we made money in every year but 2 of the last 12 full calendar years, including the 2000 down market year. Hardly results associated with high risk takers.

It was unfortunate that some of our holdings became higher risk in the Panic—for some, their risk characteristics changed as a result of the impact of the credit crunch on their debt levels that increased after we had acquired them. And, we did not react fast enough, nor could we have because of the unique volatility, to limit outsized losses—most of which occurred in the 3rd and 4th quarters of 2008. We believe a market like that, the worst since the Depression, is unlikely to occur again anytime soon, nor do we believe we currently have securities in our portfolios that are similarly vulnerable. The operational, financial and valuation risks of our current holdings in general are lower. And, we intend to react more vigorously should those factors change. We don't believe we erred in buying some of those holdings that ultimately became permanently impaired in 2008, but we do regret not selling them soon enough when circumstances changed.

Our Mandate

We know what our objectives are for you. First, to preserve capital, though from time to time some volatility may temporarily but not permanently affect the quoted capital. And secondly, to get you absolute (positive, not just relative to the market) returns which are superior to the overall market.

And we think we have an edge. First, we have a value bias. We only want cheap ideas. We don't chase growth. We want companies that have good balance sheets. And we have an all-cap orientation. Conventional wisdom is that small caps are riskier than large. But bigger is not always better. Witness what we have just lived through where some of the biggest caps went, or essentially went, off the board—Lehman Brothers, Bear Stearns, Nortel, GM, Merrill Lynch, AIG, Fannie Mae, Freddie Mac, Blockbuster and Circuit City.

We do comprehensive fundamental analysis in-house with our analytical team and review the analysis of other outside experts we hold in high regard. We interview management where we can—obviously in all the small and mid-cap names. We use our proprietary TRAC™ and TRIM™ work to select optimum buy and sell points, and to anticipate market declines. And we regularly 'shuffle the deck,' that is, reducing or replacing holdings in our model that have lower anticipated returns from having appreciated or where our expectations have been reduced, and adding or increasing the weightings of names that we believe have lower risk and better potential. And, as you know, we always take account of the macro picture, the top-down effects, whether economic trends, inflation risks, interest rate and currency directions, investor psychology and any others that we think could beneficially or negatively affect your stock and income portfolios. We try to determine whether any shift in risk is merely temporary or a more sustained change and, where necessary, we attempt to rebalance our portfolios. And, we may hedge currencies to protect against that risk of loss. And hedge

downside too by short-selling overvalued securities in our long/short accounts. And, for accounts that have authorized it, use option strategies to reduce risk and enhance returns.

Oh, and we diversify, but are not afraid to be concentrated more in the best sectors and names, as we are now in energy. Today, as inflation picks up we feel comfortable holding stocks backed by hard assets whose underlying commodity prices should keep pace or perhaps outpace general price increases. Sure, companies that produce a commodity, the price of which may fluctuate widely, can be considered higher risk. But, for most of our resource-based holdings, this is offset by a number of factors. First and foremost, our outlook is for high oil, gas and gold prices. Second, in view of their lower production costs, the companies we own should remain profitable even at somewhat lower commodity prices. Third, due to the existing undervaluation and growth prospects, there is upside potential to the share prices even at lower commodity prices. Finally, if the companies have exploration success then they may become even more valuable than our current appraisal.

Top Holdings

We need to do a better job of articulating to our clients and prospective clients the protection offered by our downside analysis, especially given the backdrop of '08/09 which has made everyone overly attuned to risk. With that in mind, our top holdings appear to offer the following prospects (note that our resource-based reserve or net asset values imply a 10% discount rate):

Corridor Resources has limited downside to its reserve value. Applying a mere 2% chance of success to the Frederick Brook shale (too low given Corridor's initial shale drilling results and the company's belief that it has a commercially viable shale project) gets us to today's share price. Corridor recently announced mixed results. On the one hand, the first 2 horizontal shale wells drilled by its joint venture partner, Apache, appear to have been drilled/completed improperly and are so far not commercial. However, both encountered strong gas shows while the wells were drilled. And Corridor reflowed its adjacent G-41 well, its first vertical shale well, with excellent results. It appears to be only a matter of time before Corridor and its partner commercialize the shale project. While it may take longer than anticipated, the size of the prize should be well worth the wait. Financially, Corridor is lower risk. It has no debt, and cash flow is sufficient to cover its current capital expenditure plans. Operationally, it's a low-risk producer, located in a favourable jurisdiction close to the best gas markets in North America. And, Corridor's existing McCully Field has proven to be lower risk with over 90% of wells drilled commercially successful.

Our upside target is \$16 over the next 3 years or 50% per year. That includes our estimate of the current reserve value plus only a fraction of the potential value of the 59 TcF Frederick Brook shale resource with zero value ascribed to: higher natural gas prices; Old Harry in the Gulf of St. Lawrence (potentially 2 billion bbls oil in place where we anticipate a partner shortly with drilling to begin in late 2012); Anticosti Island (multi-billion bbl potential shale oil play where we also expect a partner to be announced this year); Caledonia (several potential oil wells); and the Dawson Settlement zone where 5 TcF of potential gas in place could exist in this deep zone.

St Andrew Goldfields' net asset value, at only \$1200 gold (well below prevailing prices), is 20% higher than the current market value. The company had net cash on hand of over \$30 million at year end. It operates in Ontario, has a state-of-the-art mill, relatively uncomplicated mines, costs that are not high around \$600 per ounce, substantial resources and reserves, and plenty of opportunity to grow through exploration, holding the largest land position in the Timmins mine camp (the third most prolific mine camp globally). The production estimate for 2011 slightly disappointed expectations accounting for the recent share price correction; however, the company continues to produce steady growth with 2011 expected production of 90,000 ounces versus 2010's 70,000. Production should increase in the second half of this year as the Holt mine ramps up. Even assuming no material addition from exploration growth, from its extensive annual \$10 million drilling program, we have an upside target of \$2.40 in 3 years for a 30% per year potential reward.

Even valuing *Xcite Energy* at the low estimate of contingent resources provides an appraisal over 50% higher than the current market price. The company now has net cash on hand of over \$80 million and its key asset is a lower-risk development project in the U.K. North Sea. The first pre-production well drilled was an overwhelming success. The company expects to drill its first production well in October. Our 3-year target gives us over 40% per year potential upside.

Orca Exploration has significant reserves and valuing only its reserves of Songo Songo East is an amount over 50% higher than the current share price. Orca has net cash on hand of over \$40 million and is a utility-like operation with pricing for much of its output regulated. Production is increasing, newly acquired exploration properties in Italy offer potential growth and drilling on Songo Songo West later this year could also add substantially to net asset value. Our 3-year target is \$16 which would represent more than a potential 40% annualized return.

Manitok Energy was a new position for us in Q4 2010. The value of its current production (350 bbls) plus its initial Stolberg well (1,350 bbls) only, plus the land value and cash is nearly 100% higher than the price of the recent equity issue in which we added to our position. The company now has over \$40 million in net cash. Manitok is a lower risk company with drilling focused on development wells in the Canadian foothills (mainly Alberta)—either reentering existing well bores or twinning existing wells. Because land prices in the area have come down materially and the chance of success (due to the development nature of the drilling) is high, there is opportunity for very high rates of return on capital spending. The company has an experienced management team (ex-Talisman) that has specialized in the foothills for the last number of years. Based on the newly issued equity, the company should be able to ramp production to 8,000 bpd by the end of 2012 which could increase the value of the company by more than 4 fold from the equity issue price.

Dell has \$9 billion of net cash, a healthy growing business, its status as a leading global brand is improving and, perversely, it trades at only 5x free cash flow ex the cash on hand. It's almost unthinkable that Dell could be permanently impaired from today's ultra-low trading price. Assuming no growth whatsoever in actual trailing 12-month free cash flow, the company is worth 15% more than its current share price. Our appraisal today is over

\$25 which should grow to more than \$30 over the next couple of years. That's a potential return of more than 40% per year—a double—above-market potential reward with below-market risk.

Specialty Foods, where we own convertible debentures, is expected to have cash on hand at year end equal to our current carrying price. The company is highly profitable and there are opportunities for it to grow its business. It manufactures and sells Nathan's Hot Dogs, the number one U.S. brand, and while the contract with Nathan's is set to expire in March of 2014, even if not renewed the convertible debentures should have an equity value that is worth 100% more than today's carrying price.

Porto Energy (held only in our taxable accounts) came with its IPO at \$1 per share in the last week of March and is now trading publicly. The company controls considerable acreage in Portugal with a resource in excess of 1.8 billion bbls. Using only 15 million bbls, the low end of its contingent resources and a tiny fraction of the overall resources, we arrive at a value of \$1.12, about 30% above the trading price. Porto is debt free with cash of over \$80 million. It has a highly experienced management team and from its lower-risk development opportunities alone, the company should be able to demonstrate at least \$3 per share of value. Using other public company comparables places Porto's value at \$4 per share.

Hewlett-Packard, assuming no growth in actual trailing 12-month free cash flow, is worth 20% more than the current share price. H-P has shown strong growth over many years and continues to morph its business toward its higher margin repeatable service and software related segments. Unless there's a sudden onslaught of competition headed its way, the share price appears overdone to the downside. The balance sheet has little debt. Our 2-year appraisal throws off a potential return of 40% per year.

Aetna, where our thesis is now playing out ahead of schedule, assuming no growth in actual trailing 12-month free cash flow, has a value that is 13% above today's share price. The company has little debt on its balance sheet and operates a lower risk health insurance business where barriers to entry are high and growth is reasonable, from aging demographics, the need to lower health-care expenditures and the potential for the company to increase its margins through enhanced pricing. Our 2-year target provides a potential annualized return of 25%.

Not only is the valuation risk low for all of these companies in that even our downside analysis (should our base case not pan out) throws off values above current market prices, but these companies also have lower than average financial risk with clean or cash laden balance sheets, and also lower than average operational risks—operating in safe jurisdictions and/or low cost operators and/or operating at stable profit margins that have potential upside.

New Positions

We have recently added four new positions:

Southern Pacific Resources is an oil sands producer. Its current Saskatchewan SAGD production alone, which exceeds 4,000 bbls per day, nearly justifies the share price. And, when we add the value of its Athabasca oil sands McKay project, where 10,000 bbls per day come onstream in late 2012 (full run rate by Q1 2013), our total net asset value is over 3 times the share price. The company has fully funded its expansion plans with recent debt issues but we're comfortable with its debt level as it should get paid down quickly. Even if the expansion were to be derailed, the cash flow from the existing production alone could pay off the debt in a reasonable time frame. The new project is low risk. The reservoir is high quality. The reserve life of the assets is over 25 years. Assuming only an \$85 oil price our 3-year target is \$6, more than a 45% return per year.

Cline Mining is a metallurgical coal producer based in Colorado. From 1953 to 1989 the mine produced coking coal for a local steel company but closed when its customer switched to electric power. The company restarted production late last year and should hit its full run rate by the end of this year shipping to overseas customers. Coal prices are well over \$225 per ton, but for our analysis we used only \$160 per ton, and derived a net asset value nearly 70% higher than our recent acquisition cost. Our conservative 3-year target is about \$8 per share or 25% per year higher than the current share price. Cline is debt free and has over \$40 million in cash. It has a resource that is expected to last until at least 2030 and could generate additional value from non-core assets.

We just added *Pivot Acquisition* to non-registered (because as a private company it does not qualify) income and equity accounts—a convertible debenture with a 12% coupon. Pivot is a private company which intends to go public in the next few months. It should produce over \$50 million of pre-tax earnings this year from its value-added IT reselling businesses. The company's cofounder and managing partner is John Sculley, the former CEO of PepsiCo and Apple, and its CEO, John Paget, ran major divisions at GE, and was the CEO of CIC Systems and the President of Avnet prior to launching Pivot. We see very little risk operationally and the valuation is highly compelling. The conversion price is extremely favourable (half the IPO price) and if the company fails to list within 12 months we receive a 10% bonus. We anticipate a double in the next year.

Finally, we added *Fortress Paper*. The company is a specialty paper producer with plants in Switzerland (banknote and passport paper) and Germany (nonwoven wallpaper backing). Its newest addition, and key driver for the business, is in Quebec. The Quebec plant is being converted to produce dissolving pulp which is used in rayon—a cotton substitute. Cotton supplies have suffered due to adverse weather and lack of dedicated land as other crops have been preferred. At the same time, textile manufacturers have favoured the moisture absorption features and aesthetics of rayon. The dissolving pulp industry is operating at full capacity and supplies should remain tight for years. After a serious run up to \$63, the stock recently pulled back to the low \$40s. The company has no net debt and trades for less than 5x next year's earnings. Using the low end of the company's hedges—which extend for up to 10 years—we arrive at a low-case value of \$80 per share. Our actual appraisal is over \$100 per share and, with growth, our potential 3-year return is in excess of 45% per year.

We're also now renewing, and in some cases adding to, our *Advantex* debentures. The company has renewed contracts with both Aeroplan and CIBC. Other partnerships are likely to follow. *Advantex* should generate around \$3 million in EBITDA in the next 12 months as its merchant base has grown dramatically and we estimate those annual profits should rise to about \$10 million over the next 3 years. Our 10% secured convertible debentures are being exchanged for 12% secured non-convertible debentures with warrants exercisable at \$.04 per share. The company should be worth many more times that over the next 3 years.

We also had some recent dispositions. We sold our *Petrolifera* position after the takeover by *Gran Tierra* was announced, our *CVS* shares once it rose closer to our Fair Market Value estimate, the balance of *Jack In The Box* and our *Aurcana* position after it moved up significantly with the price of silver.

Though we'd like to buy more *Dells* and *Hewlett-Packards*—undervalued big-cap stocks—the lower-risk, higher-potential-reward *Manitoks* clearly excite us more on a risk-reward basis.

Bottom line, clearly the positions we hold are *not* high risk, but do offer potential for high reward.

Income Holdings

Based on our analysis, the income securities we hold also have minimal downside. For example: *Specialty Foods* has nearly as much cash as debt; *Advantex* debentures are fully secured by the company's receivables; *Student Transportation* operates an extraordinarily steady school busing business; *High River's* debentures—the only non-project debt of the company—have material asset and earnings coverage; *CompuCredit* has more cash than next year's put price of our debentures; *Dynacor* debentures, the only debt of the company, are secured and asset and earnings coverage are substantial; *Goldfarb*, where we own common shares, has more cash than its share price (and the company has announced a payout of about \$3 per share by mid-June); and *Ticketmaster* bonds should be priced higher given its oligopolistic position.

We recently bought the 9.75% *Seitel* bonds due in Feb. 2014. And, we also bought the 6% June 2016 convertible debentures of *Southern Pacific Resources*, a company described in our equity discussions above. The conversion price is only \$2.15 and our 3-year target price is \$6. And, as mentioned above, we are either renewing or adding to our *Advantex* position.

Other than the fact that a number of our income positions are now denominated in U.S. dollars, which could pose a risk if the U.S. dollar, already cheap compared to the loonie, continues to fall, we see little risk with our income positions. At the same time, a number have well above market yields and in a few instances offer potential conversion privileges which could lead to substantial capital gains.

We just sold our *AT&T* common shares. Though *AT&T* still yields more than 5%, the stock price had risen closer to fair market value. We're looking to replace it with other blue-chips.

All Else May Not Be Equal

What could go wrong? Hey, the best laid plans of mice and men. Well, interest rates could rise dramatically in an inflationary shock—therefore, lower P/E multiples—though we own lots of hard-asset type stocks which would benefit and also big-cap stocks that have pricing power and already trade at single digit multiples. The economy could slow into recession, once again hurting all stocks. And, even if the sky itself doesn't fall, something could certainly fall out of the sky and land on one or more of our holdings—an unforeseen event that could hamper the value of an individual security. Like the Bhopal incident years ago for Union Carbide, the Salad Oil Scandal for American Express, or the recent tsunami for Japanese stocks. Risks like these are impossible to predict. That's why, though we concentrate weightings in accord with our ranking of our most compelling risk-reward situations, we do diversify among holdings. All else being equal, should all of our holdings live up to our expectations, we expect outstanding results.

What could go right? Well, the economy is recovering from recession. Countries are finally having to deal with their deficits, including the U.S. where Democrats and Republicans have both put forward plans to reduce the deficit by some \$4 trillion over the next 10-12 years. Progress. U.S. unemployment is improving with private sector hiring picking up. While U.S. investor confidence may be low, consumer confidence is actually rising more than expectations. The U.S. dollar is weak which will make import prices higher allowing domestic producers to raise prices and stimulate exports which just made a record high. Whereas China just reported its first trade deficit. U.S. March Industrial Production was up 0.8%, higher than expected. U.S. housing is very affordable and a little more inflation will induce buyers to step up their house buying intentions. Rent inflation is up. March existing home sales were up 3.7% and new home sales were up 11%.

Individual investors, always late to come in to bull markets, and late to exit, are finally moving back from bonds to equities. Rightly so, since equities are still undervalued, P/E ratios are relatively low compared to historically low interest rates, cash on the sidelines by the U.S. public is high (\$7.9 trillion) and U.S. corporate cash levels are high (\$2.4 trillion domestically alone). Most important, earnings reports are generally beating expectations, forward earnings for the S&P 500 are at all-time highs, and earnings are the prime market driver. This bull market has a long way to go. Consumer and investor confidence will improve. Sweet dreams ahead for stock investors and our clients.

Now Is The Time

We think now is an extraordinarily good time to add to investments with us. Our level of confidence is unusually high because the large-cap indexes are undervalued by about 15%, stocks today are by far the preferred asset class over bonds and cash, our TRAC™ and TRIM™ work are positive and, most important, risk-reward parameters for our individual holdings are so highly favourable.

Inflation is now annualizing at more than 3% in the U.S. and 5% worldwide. Cash and bond yields are currently not compensating for inflation. At these escalating levels investors need to seek higher returns to simply maintain the real value of their assets.

We are not trying to shoot the lights out. We merely want to find as many lower-risk-of-permanent-impairment securities that are ‘on sale,’ offering above-average reward potential. Even allowing for normal errors in judgment, with hopefully nothing unusual falling out of the sky onto our businesses, we should enjoy superior returns. With lower than average risk. Clients often tell us, they don’t want to make big returns, just a steady 8-10%, allowing them to ‘sleep at night.’ We think our current portfolios are the tonic for peace of mind. We’re not necessarily aiming high, but neither are we aiming low. If an investor’s objective is average returns he or she may end up with a less than desired, or even required, outcome.

If this letter does not help you sleep better please consider warm milk before bedtime. Though Herb actually prefers a different nightcap.

Herbert Abramson and
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April 27, 2011

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