RIGHT BRAINS AND THE DISMAL SCIENCE

It has been said that successful investors need to employ not only the left side of their brains which is the analytical or scientific part but also the right side which is the centre for creative or intuitive thinking. That's because much of investing has to do with the unpredictable, the "down cards", variables about future demand, growth, political policy changes, political will, psychological responses, weather, oil spills, and so forth. Of course, value investors don't want to pay for the down cards, for the future, for the growth, but want to buy so cheaply in "the here", based upon the up cards, that there is little or no downside risk of losing, and "the hereafter" can take care of itself.

Sounds simple. But occasionally, extreme and unusual macro events such as the meltdown of '08/'09 are of such a magnitude they wreak havoc even with the really, really cheap ideas. And create painful declines which most, including us, didn't avoid, though much of it was temporary, and, thankfully, most, including us, are now enjoying the significant recovery. Our left brain could not have imagined the carnage in big caps, and the wasteland in small and mid caps. A right and left brain headache.

But we are indeed enjoying the recovery after our disheartening 2008, with significant gains over the last two years. And our long-term track record is intact. All of our growth composites—long/short, long-only and RSP—had positive performance and outperformed our blended benchmark[1] in 8 of the last 10 years.

Both sides of our brain are now telling us that the worst is over, that governments, businesses and consumers are reacting to the ugly events and, as such, sowing the seeds for a healthy and continuing recovery.

The Dismal Science

If it is a science at all, economics has been called the dismal science. Unlike real science, economic outcomes are not invariably predictable—as Newton's Law of Gravity or $E=MC^2$ or Salk's polio vaccine. Economists look at the current and the past to ordain the future despite so many unpredictable variables—and dependent on the accuracy of inputs—not always reliable, often adjusted for seasonal or other factors or whatever and often revised. As the esteemed economics professor, Ludwig von Mises, once wrote, "As there are in the field of social affairs no constant relations between magnitudes, no measurement is possible and economics can never become quantitative." That dismal science.

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[1] The blended benchmark consists of a blend of the following indexes so as to reflect the all-cap nature of Trapeze's portfolio management style and our long-term neutral position for "Growth" accounts: Canadian Large Cap (S&P/TSX) = 20%; Canadian Small Cap (S&P/TSX Venture from Jan. 1, 2002 and BMO Nesbitt Burns Canadian Small Cap Index for periods up to Dec. 31, 2001) = 30%; U.S. Large Cap (S&P 500) = 40%; U.S. Small Cap (Russell 2000)= 10%.

And many of its practitioners these days are dismal indeed. Nobel laureates, Joseph Stiglitz (who believes excessive austerity risks a slowdown from reduced needed demand and that high unemployment will persist) and ultra-liberal Paul Krugman, who is generally bearish; Lacy Hunt who believes GDP growth will start to slow this year; Gary Shilling who agrees and recommends buying Treasury bonds and if you're thinking of selling your house, sell *now*; Dr. Doom, Nouriel Roubini who was right about the Crash and is now addicted to them (but now, a latecomer, warming to the stock market); and David Rosenberg who believes we are in a bear market rally that "will end in tears," that all the positive numbers are consistent with a peak and that the bond market is "a nice buying opportunity." Scary stuff for mere investors to digest, or indigest.

But wait, there are other dismal scientists who are not dismal at all, who, for example, predict growth in coming decades from emerging countries that will be strong enough to boost developed countries. Gerald Lyons, chief economist for Standard Chartered, predicts a "super cycle" of historically high growth lasting at least a generation and led by booming trade, investment and urbanization. He says such a cycle has occurred only twice since the end of the 18th century: the four decades before the First World War and the three following the Second World War. And he says the 30-year bond bull is over. Sell bonds.

Paul-Andre Pinsonnault, senior fixed-income economist with National Bank Financial Group, believes that recent economic data leaves him confident that monetary and fiscal stimulus will lead to a significant improvement in U.S. labour markets.

Peter Hall, chief economist at Export Development Canada, said encouraging signs are starting to appear in the U.S. as demand accelerates from tax cuts and increased savings. He raised his forecast for global growth to 4.2% in 2011 and a full percentage point for the U.S. economy to 3.2%.

Arthur Laffer, who even surpassed Sandy Koufax by having a curve named after himself, is suggesting lower taxes which in the end generate higher government revenues, antithetically to Krugman, and now suggests lower taxes and lower spending as the way to solvency and prosperity.

And economist Ed Yardeni notes, bullishly, that consumers are exceedingly liquid and corporations are generating cash faster than they can reinvest it, with balance sheets better than any time since the early 1960s. And that, "While the recession was the worst since the Great Depression, the recovery has been one of the best." And that today's global liquidity is bullish for stocks but that bonds should be underweighted. "Overweight inflation," "Underweight deflation," he notes.

Richard Dobbs of McKinsey & Co. sees an imminent end to cheap capital from a building bonanza in developing economies. Jim O'Neill of Goldman Sachs believes world economic growth is being lifted by the BRIC economies and forecasts higher U.S. bond yields in 2011. Edward Prescott, a senior advisor to the Federal Reserve Bank of Minneapolis, who shared the 2004 Nobel Prize for analysis of business cycles and economic policy, believes "the whole world's going to be rich by the end of this century." Clearly a long-term investor.

The IMF itself just boosted its growth outlook for the global economy on the heels of stronger U.S. consumer demand and robust emerging markets. And the cautious Fed just raised its GDP forecast for 2011 to 3.4-3.9%.

Who's to be believed? Well our left brain tells us economists are clearly divided in opinion but generally have a dismal record of forecasting correctly. Wasn't it economist John Kenneth Galbraith who said, "If you're going to forecast, forecast often"? Besides, generally, economists are lousy investors. Didn't Lord Keynes have to be bailed out a couple of times? There are so many variables to be accounted for. Interesting that defunct Long-Term Capital had two Nobel prize winners for Economic Sciences on its payroll. Which is why Trapeze has a policy of not hiring Nobel prize winners.

Our right brain is telling us that the world is reacting to the last ugly episode by being very alert to the possibility of a recurrence, therefore probably making one unlikely. What both lobes are detecting is the possibility, indeed the likelihood, of more inflation. If, as the late renowned economist Milton Friedman argued, that "inflation is always and everywhere a monetary phenomenon", it's bound to be coming, from all the money printing, quantitative easing and the recent pickup in the velocity of money.

Moreover, central bankers, including the U.S. Fed and the Bank of Canada, prefer some inflation, with 2% as their target. Deflation is what they're working hard to avoid. The Fed funds rate remains at zero. Remember the rule, don't fight the Fed. Commodity prices, usually a precursor to general inflation, have been rising—copper and cotton at all-time highs, sugar and coffee at multi-year highs, but all commodities, including gold and silver, strong too. The outlook for oil, a very important commodity, seems higher too, and corn, wheat and foodstocks generally are in short supply worldwide. Likely contributing to the recent civil disorder around the world.

The current historically low interest rates are conducive to spending and to speculation, not to saving. Reflationary, and likely inflationary. While recent economic news has been positive, including the recent unexpected drop in the U.S. jobless rate to 9%, the lowest level since April '09, and jobless claims the lowest since July '08, apparently it is still not enough to dissuade the Fed from continuing to pump money into the economy until it deems the recovery firmly established. Therefore, look for continuing low interest rates, increasing money supply, huge budget deficits, pressure on the U.S. dollar, higher import prices—the potential for more inflation. Characteristically, Central Banks tend to stay looser longer than necessary, risking more inflation than necessary. Even those helicopters from which Fed Chairman Bernanke says he'll be dropping the money will cost more.

More Good News

We suspect the really dismal scientists must be getting frustrated from the recent upbeat news. Good for the economy, bad for their jobs. Momentum seems to be gathering. Retail sales for 2010 reversed two years of contraction with the biggest gain in more than a decade, and a better than expected January rise of 4.2%. January chain store sales were higher than expected too. Growth in the U.S. services sector (non-manufacturing) was the fastest in more than five years, surprising economists. And ISM manufacturing activity in January increased to its best

reading since May '04 and was the 18th consecutive month of expansion, the employment index surging to a 38-year high and new orders to a 7-year peak. Dismal?

On the other hand, as to our concern about inflation, the prices paid components, measuring commodity production inputs, grew significantly, a portent of future margin pressures and, ultimately, higher prices from pass throughs. More inflation, our right brain bias.

And the big one—the overall economy gathered speed in the fourth quarter, GDP growing at a 3.2% annual rate, from the large gain in consumer spending and strong exports, even without help from inventory rebuilding, essentially removing doubts about the recovery's sustainability. Except from the hardcore, diehard, double-dip, dismal group—the 4 Ds. Real final sales of domestic product, excluding inventories, jumped at an annual rate of 7.1%, the fastest quarterly rate in 32 years. No dismal here.

Confidence Is Not Dismal

Productivity, or output per worker, remains strong as business is slow to hire during a recovery from a recession. But business leaders' confidence was at its highest in 6 years in the fourth quarter of 2010 and many firms are operating close to or above capacity, with plans to increase capital spending over the next six months, which likely means workers will be hired at a faster rate. That clearly will be good for consumer demand.

Meanwhile, U.S. consumer confidence improved more than expected in January to its highest level in eight months, even though the housing market is still shaky. The index was above economists' expectations reflecting an improving outlook for employment and the economy. Of course the S&P, having now doubled from its March '09 low, is certainly a boost to confidence. And while declining a bit, the savings rate is still a respectable 5.3%—wherewithal to power demand.

While dismal scientist Gary Shilling believes U.S. house prices will still decline by 20%, our right brains suggest that with housing still very affordable and inventories declining, if and when the inflationary psychology we expect kicks in, and potential house buyers then believe prices generally, including house prices, may rise, an urgency to buy will help reduce excessive inventories. This, of course, while new houses necessarily become more expensive to produce from higher lumber, copper, brick, labour and land prices. Because housing is such a large component of the CPI, on any recovery it in itself would push reported inflation higher. Rents are rising, an incentive to own, particularly where mortgage interest and property taxes are tax deductible. Interestingly, U.S. new home sales were up 17.5% in December, much higher than expectations, and housing starts also up more than expected.

Meanwhile, global equities have climbed to the highest level in more than two years, giving investors more confidence, not to mention more wealth, to spend. With much more to come. Cash on the sidelines in the U.S. is equal to the value of all stocks, compared to only 50% in 2000. And money is starting to come out of bonds and into stocks. Deservedly so. Especially with a whiff of inflation in the air.

Stocks Compelling

Valuation for stocks is attractive and the outlook for profit growth is excellent. Dividend payouts are increasing as are share buybacks. Corporate profits are at a record while sales are just 6% below all-time highs. Yet share prices are still considerably below their record highs. The S&P is selling at about 13.5x this year's earnings, below the 15.3 average P/E for the last 40 years, and an 18% discount to our Fair Market Value. S&P operating margins are expected to exceed 9% of sales in 2011 compared to the 6% level of only 3 years ago before the recession.

Of S&P companies reporting Q4 earnings so far, 72% have posted a positive surprise, with earnings 40% higher than a year ago. Importantly, 65% of companies recorded a favourable sales surprise, sales up 9.6%, and the outlook for sales growth in 2011 is rising, a sign of healthy earnings power beyond cost cutting and productivity improvements.

No matter what the really dismal scientists are advising, our left brain can see that current S&P earnings are at a record high and rising, and that the earnings yield on the S&P makes stocks very cheap compared to corporate debt, treasuries and cash. And our right brain perceives that the glass is filling and that stocks should continue to be the compelling place to put your money, especially with continuing support from the Fed.

Bond yields have recently started to climb but equities should continue to outperform as money moves from bonds to equities particularly as U.S. equity allocations of households and pension funds are at 15-year lows.

While private sector balance sheets are good and improving, the overindebtedness of federal and state governments has to be, and is generally being, addressed. Obama's new budget proposals were intended to have government start to "live within its means" though the projected fiscal deficit is even higher at $1.65 trillion. But the Republicans are on the case. Necessity is the mother of invention. Welfare states everywhere are taking measures to cut spending and reduce deficits, including raising retirement ages, as in Greece, France and the U.K. The glass is necessarily filling, slowly but surely.

Though we try to follow what the lofty economists are saying, diverse and confusing as it often is, as mere investors for our clients and ourselves we are more scorekeepers than forecasters, but sometimes we need to embrace some important likely change that our left and right brains perceive which is generally not "in the market." Not just a brain perception but all the way down to a gut feel. Both parts of our anatomy now perceive a risk of more inflation. Whether or not the economy is stronger. Inflation can be present in a strong economy or there can be stagflation in a weak one—even hyperinflation in a depressed one, Zimbabwe for example. In the inflation spectrum, deflation is highly undesirable because it discourages spending and encourages excessive saving. Japan, for more than 12 years. On the other hand, China had almost 5% inflation last year, mainly from higher housing and food costs, and has just raised interest rates again, for the third time since October. Naturally, this strengthens the Yuan making Chinese import prices into the U.S. higher, in turn contributing to U.S. inflation. Indeed U.S. January wholesale prices were up for the seventh consecutive month to 0.8%. U.S. consumer prices in January were up 1.6% year-over-year, slightly higher than expected, the core rate at its quickest pace in 15 months. Excessive inflation is bad as consumers'

savings and incomes can't keep up with rising costs. However, modest inflation is desirable, and governments everywhere desire it, especially the U.S. with its growing federal deficit (10% of GDP) and $14 trillion of national debt, a good part owed to foreigners. But that debt could shrink relative to an inflating economy and, if the currency declines, allow the debt ultimately to be repaid with cheaper dollars. It's a game Central bankers call "Shaft the Lender."

Current economic and monetary policies are driving inflation. It's what's wanted. In its early stages hard assets and stocks are better than bonds and cash. That's today. As inflation rises, however, so inevitably do interest rates, putting a brake on affordability and corporate earnings and making bonds and cash more competitive with stocks, as in the early 1980s. So, as interest rates rise, we will need to be cautious about that competition and the risk it portends to our equity holdings.

Focused On Value

Like economists (or perhaps because of them) our clients have divergent opinions. Post Panic, understandably, we get queries regarding our investment process: Why are you adding small caps? Why more large caps, isn't your specialty small caps? Why the emphasis on oil and gas holdings? Don't we need more golds? Shouldn't we be hedged more? Why do we short if the market's rising? Valid concerns.

Well, because in the main, it has worked well over many years we have not altered our investment style. Our concepts of value investing are immutable. Though the irrational behaviour of the market to the downside in the Panic has made us even more focused on risk management.

We consider ourselves investment specialists who constantly seek out undervalued securities. We have been and remain fully invested in our undervalued large caps and small caps, with a small hedge from 4 overvalued short positions which comprise about 10% of our mandated long/short accounts. The 4 are in the consumer discretionary segment, 3 of them restaurant stocks, after each of these stocks had material rebounds well surpassing their Fair Market Values (FMVs) to ceilings in our TRAC™ work. Though bullish on the overall market, we lifted our short exposure given the overvaluation of these specific securities in what we believe is an extended sector.

Bottoms Up—Bigger Is Better

Not a toast, but a recommendation that investors today, while not entirely ignoring the confusing macro, should foremost focus on and emphasize the micro opportunities in cheap stocks relative to all else.

We have now been able to increase our weighting in large-cap companies, because they are unusually cheap. Large-cap stocks currently trade at their lowest valuation compared to small caps since 1982. And, bigger is usually better—more liquid, experienced managements, strong market shares with presences in growing emerging markets, good balance sheets, low borrowing costs and so on.

Bigger is also better, inasmuch as we can more easily exit larger cap positions if we get a TRAC™ sell signal or our opinion has changed or we are fearful of an overall market decline. But, we are otherwise indifferent to whether our holdings are small or large cap, though our return expectations need to be higher for small-cap holdings and our anticipated hold period longer, thereby potentially offsetting the liquidity risk (i.e. being stuck) inherent in smaller company positions.

We now own several large-cap familiar names. *Hewlett-Packard* for one. We believe resurgence in the entire global IT space lies ahead. Corporations restrained spending since the recession and are now flush with cash and refresh cycles are reasonably short. HP has also reinvented itself somewhat into a service provider and that business, along with its staple printers and associated cartridges, is thriving. The company trades at 8x free cash flow offering upside to a revaluation back to its growing FMV. If the 35% discount to FMV is alleviated in the next 2 years and the FMV grows by 8% per year then HP could deliver a 35% annualized rate of return in 2 years.

Dell is our latest addition. Somewhat misunderstood, as the consumer PC business for which Dell is widely known now only represents less than 3% of profits. Like IBM, HP and others, Dell has morphed its business toward the enterprise market and IT services. What attracted us to Dell now was the recent lift in its FMV—it is adding value again—to the mid $20s while its share price sank to a floor in our work just below $14. And the company has $9 billion of net cash and generating more from record earnings. Excluding the cash from the overall enterprise value the company is trading at a mere 5x free cash flow, remarkable, for one of the top brands on the planet. Michael Dell has the reins again and insiders are buying. There is a clear strategy for growth, even for the PC business, headwinds seem to have evaporated and Windows 7 (a successful product whereas its predecessor Vista was a bust) which only has 20% penetration should alone provide growth as consumers seek to upgrade. A simple jump back up to 12x free cash flow, plus the cash and the reasonable growth we expect has the potential to lift the shares by over 40% per year over the next couple of years.

Aetna's recent results exceeded the market's expectations and lifted the stock. Its medical loss ratio fell smartly, guidance was raised by about 15%, the company bought back about 5% of its outstanding shares and it lifted its insignificant dividend to a respectable 1.6% yield. Generally results improved as the company has been pricing its risks better. Aetna has now shown meaningful recovery in the profit margins that we had been anticipating. Our thesis is proving correct and the stock remains undervalued at 10x earnings with a 30% annualized return potential over the next 2 years.

We added *MasterCard* late in 2010 after its share price declined to a floor on the news of regulatory reform which could hamper debit card transaction fees. It's not often one can find a rapidly growing, world-class franchise opportunity at 13x earnings. When Mastercard sold off on news that our analysis suggested would only knock 5% off earnings, if any at all, we took a position. The share price has lifted in the last month and now offers a 21% potential annual rate of return to our FMV in the next 2 years.

We also added *VISA* in our "big cap" mandated accounts. Visa, the preeminent player, suffered from the same news as MasterCard. We established the position at a floor in our work at a reasonable discount to our appraised value.

Bottoms Up—Less Is More

We are constantly on the hunt for more Dells and MasterCards, though the favourable risk/reward metrics of our small caps clearly excite us too.

While bigger is usually better, less is often more. It has to be. We would only add small and mid-cap stocks today if they were exceptionally cheaper with exceptionally more upside opportunity than their large-cap brethren. Sometimes small caps are so cheap they literally can't get much cheaper from being so underowned. Our small-cap investments in the past few months have given us exemplary returns with exemplary future potential.

We strive to ensure our bottom-up security selections coincide with our macro top-down views. Thus, we continue to concentrate in oil and gas shares. The demand for oil is at all-time record highs. And, global production levels are having a hard time keeping pace. Charles Maxwell, renowned in the field, believes that oil production will stop growing altogether by 2015, driving energy prices substantially higher over the next few years. We believe a similar outcome is in store for natural gas prices as the higher inventory levels are worked off over the next couple of years and natural gas, which is the favoured clean energy solution, sees demand far outstripping supply.

On a bottom-up basis we constantly compare individual securities in which to invest. The energy sector offers no shortage of attractive opportunities. Sometimes when we may have a specific macro view, as for example, higher gold prices, finding the individual securities—gold stocks—with favourable risk-reward parameters may be more limited, as is the case now.

Corridor Resources is our largest holding. It meets our criterion of lower than average risk and higher potential reward. The company is debt free, is a low-cost producer, in a favourable jurisdiction (New Brunswick—where royalty rates are low and political risk minimal) and receives above average gas prices due to the heat content of its gas and proximity to the best gas markets in North America.

Most of Corridor's assets today are natural gas based. The fact that gas prices remain below the North American marginal cost of production and are likely to trend much higher also attracts us to Corridor. Natural gas prices have been held back by weaker industrial demand from the recession, excess supply from shale discoveries and continued drilling facilitated by hedges at former high prices. But demand is recovering, hedges at higher prices have dropped off and most E&P companies are focusing on oil. Supplies are beginning to come down both naturally from normal gas well annual decline rates, about 24% annually on average (much higher for shale wells) and from declining capex. We anticipate substantially higher gas prices over the next few years.

Corridor's stock price fell in late 2010, an overreaction to a press release that the timeline for the drilling results from two shale wells would be delayed as the frac fluids (mainly water) were not coming to surface fast enough. Both Corridor and the operator, its joint venture partner Apache, were perplexed as they had anticipated meaningful immediate gas flow from these very thick shales, strong gas shows in the drilling and high pressures. These wells are now being analyzed and, we believe, pumps are in place to help remove the water. In other

shale plays, up to 60% of the water needs to be removed in order to allow gas flow (up to only 10% had flowed out naturally in early December). We anticipate merely a few weeks' delay in the process as they work with experts to expedite the project even though the market was reading failure. Though, most importantly, Corridor has already been successful finding shale gas and Apache was brought in to help exploit the immense shale resource with its technical expertise and capital.

Corridor's shares remain highly compelling. The Frederick Brook shale, where Corridor has already made discoveries in two wells, could add substantially to the company's $4 per share proven reserves and land value. Corridor's independent engineers have assigned a massive resource of 59 trillion cubic feet of gas to Corridor's Frederick Brook shale. Risking the 59 TCF (62% for Corridor) at a 30% recovery factor (Apache's factor), a 40% risk factor and only $0.33 per mmcf in the ground, adds a potential $15 per share to Corridor.

Old Harry, its prospect in the Gulf of St. Lawrence could add another $17 (a potential 2 billion barrels of oil in place, based upon only $12.50 per bbl in the ground, a 25% risk factor and a 25% interest for Corridor assuming they farm out 75%. We anticipate a joint venture announcement in the next few months.

There may also be significant value from Anticosti Island in Quebec where Corridor controls 900k acres of a potential oil shale and just announced the analysis of highly prospective results from core samples. It should land a joint venture partner expert in shale oil for the play this year too.

Corridor may also have an oil discovery on the JV property with Apache where they are now conducting tests on its G-36 oil well which could be a play with some 12 potential wells.

We've ascribed no value to either of these last two mentioned prospects though both could be meaningful to the company. The risk-reward for Corridor remains highly favourable, yet we are only paying about $1.50 per share, or less than $150 million, for all of the upside over the value of its reserves and land. Apache alone will likely end up spending $125 million to earn 50% on a portion of Corridor's shale properties pursuant to the JV agreement.

We did sell some Corridor in November above $7 to reduce our weightings where we believed they were too high and then bought back on the overreaction in early December in the $4.40 range. As an added endorsement, the Children's Investment Fund (a value oriented UK based fund) bought a sizable position in Corridor over the last few months.

The value of Corridor today is above $10 per share and our 3-year target is $16, a greater than 40% potential annualized return.

Xcite Energy has now appreciated into one of our largest positions. The company completed a successful commercial flow test in December, flowing a higher than expected 3,000 barrels per day from a low-risk development well which had an over 90% chance of success. Yet, the market had been treating it as if it were a wildcat well and affording little value to the company. The result should now enable Xcite to establish significant reserves. And, the reservoir quality is even better than expected which should lead to enhanced economics when production begins. Oil production is expected to commence within 90 days of spudding the

initial production well this October. The result also lifted the expected recoverable resource above 200 million barrels (without enhanced oil recovery). At that level Xcite would be the second largest independent operating in the North Sea.

With over $25 million in cash on hand, plus funds from minor additional dilution, the company should be able to finance its pre-production expenditures prior to becoming self-reliant when production begins early next year. Xcite trades for around $5 per barrel whereas it should trade closer to $10/bbl or an $11 share price, about double its current trading price. A nearby operation, with 200 million of proven and probable barrels of reserves, was acquired a few months ago for $3.1 billion, or $15.40/bbl, and applying that valuation to Xcite could ultimately value the shares at more than $17 or 3x today's share price, with further upside potential from additional reserves, higher oil prices, other corporate ventures and enhanced oil recovery.

Last March when we first invested in Xcite, its market value was $70 million. Less than one year later, though still undervalued, it's about $900 million. Remarkably, though there is less risk today, the risk parameters have not altered materially since then. It was simply completely off people's radar screen a year ago. We often get questioned as to how it's even possible that something is that undervalued. The partial answer is that one can sometimes find those dislocations in the public equity markets when a company is totally ignored. And that's what we seek out—the unloved, misunderstood, discarded or completely overlooked—companies trading well below our appraised values.

On the other hand if a company is overly popular and trades substantially in excess of appraised value we're likely to shun it, or perhaps even short it. Nortel and Potash, both excessively popular and at one point, the largest companies by market value on the TSX, are prime examples.

Orca Exploration is another example of a lower risk investment with high potential reward. Not only does the company trade at less than half our appraised value but the company possesses many low risk attributes. Orca is a utility-like business. It provides natural gas for power, mostly at set predetermined prices, to the government of Tanzania and local industrial users. Tanzania and the adjacent regions are gas starved and require gas to power electricity merely to avoid the regular brown outs. Orca operates at low costs with high netbacks. The company now has working capital in excess of $50 million to grow its business. It had made acquisitions which we expect to add value and the western portion of its Songo Songo field will be drilled this year, potentially adding significant value. The net asset value is above $11 per share, nearly twice the share price and we expect production levels to more than double over the next 4 years. A mid-teen target in 3 years is not unreasonable which provides a potential return in excess of 35% per year.

Manitok Energy is a new holding—an oil and gas company operating in the Foothills of Alberta, it's also a lower risk company with drilling focused on development wells—either re-entering existing well bores or twinning nearby wells. Land prices in the area have come down to '98 levels as the majors already there concentrate elsewhere and the area is technically challenging, discouraging new entrants. The experienced management team formerly worked for Talisman and specialized in the Foothills for several years—one of the team members even won an award for the lowest finding costs at $7 per BOE (barrel of oil equivalent) for

3 years in a row. The company has no debt and raised $18 million to fund its drilling program. Manitok is producing 400 barrels per day (bpd) but should easily exceed 1,000 bpd shortly and with existing funding the company could ramp up production to 5,000 bpd by the end of 2012—and enough prospects in the area to take them many times above that level.

We paid $1 per common share for our position and $1.15 for flow-through common shares for some of our taxable Canadian accounts. A ramp up to 5,000 bpd could increase the company's value to over $8 per share. Our current appraised value is about $2 per share moving quickly to $3 based on our 1,500 bpd exit 2011 expectation. Low risk development drilling, a well-capitalized balance sheet to fund their well-articulated plans, a competitive advantage in their region, very high expected internal rates of return from conventional drilling and a proven management team that has drilled 50-60 wells per year in the area for several years all combine for a sound opportunity. This company was off the radar screen, only coming public last October. Our purchase price offered a drastic discrepancy between risk and reward.

In our taxable accounts (not registered accounts because, as a non-listed security, it was not eligible) we own private company, *Porto Energy*. We added to our Porto position in December. Earlier this month, the company announced its intention to complete an initial public offering, raising $60-70 million, at $1 per share. The company is headquartered in Texas, with its assets mostly onshore Portugal—a safe jurisdiction with an advantageous royalty structure. Porto has a 100% interest in 5 concessions covering 1.4 million net acres, including 7 major identified exploration trends and more than 45 mature drilling targets, mostly oil. The contingent resource on these properties is about 1.9 billion barrels of oil and the company already has a couple of natural gas discoveries which only require reserve certification and a tie-in to a pipeline to move them to proven producing status. Porto has a very competent management team, led by the former head of Devon International which his group grew into a multi-billion dollar enterprise before selling it. Applying the valuation metrics of publicly traded companies similar to Porto gives us a value of about $4 per share. An ultra-conservative valuation (giving value to only 10% of their potential resource at a mere $2.50 per barrel) gives us $2 per share today, about 3x our portfolio pricing of $.60. We had previously passed on investing in Porto until our initial purchase in the spring of 2010, after all of the key elements were in place—it no longer had leverage, it had an experienced management team in place and it had had amassed a 100% working interest in all its properties with an action plan to properly exploit them.

In December we also bought a private placement (requiring a 4-month hold period) in *Aurcana*, a publicly-traded Canadian company with silver production in Mexico and a low risk Texas mine where the funding from its December raise should allow production to start by mid 2012. Aurcana was trading well above the issue price of $.31 when the financing was proposed. The company has now fully funded its pre-production costs in Texas (a mine that their engineers consider low risk with permitting and feasibility studies fully completed) and its Mexican mine is free-cash flowing $12 million per year. The net asset value of the company at today's silver price is 3 times our cost. The management team is solid (the COO spent 30 years at Cominco). Our opinion of silver is even more positive than for gold given silver's supply/demand characteristics. Once the Shafter Mine in Texas is opened in 2012, the company will be a large silver producer, throwing off about $90 million of annual free

cash flow at current silver prices. The share price has however risen to reflect most of its underlying value unless, of course, silver prices move materially higher.

For accounts where we didn't already own a position, we purchased shares in a private placement of *Dynacor Gold Mines*, a gold milling operation in Peru originally spun off from Malaga. At our recent purchase price of $1.05 the company was trading at around 7x its current run rate of earnings but we expect the company to increase output from about 40k ounces per year to 75k ounces by 2012, at which rate the company would be trading very cheaply for only about 3x expected earnings. The company mainly custom mills gold (for others) giving it a very stable, noncyclical, gross margin of over $200 per ounce. The company also has massive potential for which we are paying nothing at its Tumipampa gold property where there's potentially a minimum of 1 million ounces of gold and current drilling, with initial results expected in the next few weeks, could provide more upside. The only debt of the company, short-term debt of less than $2 million used for working capital to ramp up production, is held by our income accounts.

St Andrew Goldfields, is our only other precious metals position. Despite its significant run up into last September, it still trades below its net asset value, unusual for a gold producer as they typically trade at premiums. We see further gains in the net asset value as the company executes on its exploration program—St Andrew is in the early days of exploring its 120 kilometre stretch of the Timmins, Ontario mine camp, the largest land package in the third most prolific mine camp in the world. We see little downside for the company, other than from volatility in the price of gold. It has state-of-the-art infrastructure and its mines and experienced management team all provide it with low technical risks. The company is free-cash flowing (with extensive tax pools to shelter profits) and the balance sheet is clean with over $30 million of cash, so there are low financial risks while the attractive valuation provides a margin of safety too. Our 3-year target, even without any material exploration success, and assuming a lower than prevailing gold price, still offers a potential return of 20% per year.

All of the above holdings meet our stringent criteria. Their balance sheets are clean, mostly debt free, often cash laden. They either have some sort of competitive advantage, are low cost operators and/or lower risk operations (i.e. high probability of success in development drilling in the case of our oil and gas investments). Potential tailwinds are also in place from our macro views that could push entire industries higher. And, most important, all are trading well below our conservative appraised values allowing for potential outsized gains.

Petrolifera Petroleum and *TG World Energy* were both the subject of takeovers in the last month. Each is being exchanged for shares of other larger complementary companies which also appear reasonably undervalued to us. We are evaluating these takeovers to decide whether to continue holding the new combined entities.

Because we felt weightings were somewhat higher, we sold a modest amount of Xcite and St Andrew shares late in 2010. We also eliminated shareholdings of Richard's Oil and Gas and Storm Cat for tax loss purposes in taxable accounts. And sold Clorox, after its disappointing quarter, and also our remaining Aflac and Goldman Sachs positions after they moved up and then gave sell signals in our TRAC™ work.

Options Strategies

We recently sent most clients options agreements for signature. For those who have not returned them, we urge you to do so. If you have questions about these intended strategies please call us. We have designed our use of options to minimize risk and enhance returns—another means to potentially protect portfolios from market driven losses. We principally buy put options (akin to paying a premium for insurance against a loss on an underlying index or security) either when the market is at a ceiling in our work and the "insurance" is cheap or when stocks are breaking down through floors and we see further losses provided the insurance is then not prohibitively expensive.

For margin accounts, we also can collect income, reducing costs, by periodically writing puts or writing calls where we collect (rather than pay) the premiums. And, there are currently opportunities to sell options (collecting premium) and buy calls with those proceeds (using the market's money, so to speak) thereby synthetically mirroring a long position. The bonus of this strategy is that we may have the same downside as if we owned the common shares outright but a significantly higher potential upside—a favourable risk-reward ratio (from the mispriced options) layered on top of a favourable risk-reward ratio (from a mispriced stock that we've determined to buy anyway).

Income Holdings

We recently purchased two new positions for income accounts—*Connacher* bonds due December 2015 and *Chuckchansi* notes due November 2013. Both provide a yield-to-maturity above 10%. Connacher is an oil and gas company operating in the oil sands, lower risk with solid earnings and asset protection. Chuckchansi is a native run casino with operations in Fresno, CA, with reasonable free cash flow and substantial profits. Either the bond (the only debt of the company) will be retired on maturity or refinanced with a replacement issue which offers us upside to the price we paid for the current bond. Both pay in U.S. dollars which is acceptable to us now that the Canadian dollar is trading above par. In fact, for our Canadian dollar reporting clients with an income mandate, we recently removed all of our currency hedges.

In December we exercised all of the warrants that accompanied the St Andrew debenture position (that had been prepaid) and then sold the common shares we received on exercise.

Specialty Foods won its two lawsuits against its licensor Nathan's—awarded $5 million for Nathan's having mispriced some products and, more importantly, Nathan's lost its suit against Specialty Foods where it was trying to end the supply contract early. Though there could be an appeal, the contract will now very likely run for its remaining period through March 2014. The company also repurchased a large portion of the outstanding debentures at $99, but we believe there could be value well beyond that for other holders who chose not to tender.

Advantex debentureholders agreed to renew the debenture that was due at the end of 2010 and roll forward the debenture that was to mature at the end of 2011. In return the company offered to raise the coupon on one of the debentures and lowered our effective exercise price on the convertible portion (which will now take the form of warrants).

CompuCredit sold a UK division and the company now has cash well in excess of the 2012 put value of our bonds. Dynacor Gold Mines completed an equity financing, increased production and profitability. It should easily satisfy its obligations to the debentureholders and we expect to receive the associated bonus amount too as the company ought to easily exceed its EBITDA threshold. *Goldfarb* sold all of its asset-backed paper and the company now has over $3 per share of cash which we expect to be paid out to shareholders in the next few months.

Sweet Spot

As value investors we often need to be contrarian and always be skeptical. Both attitudes stem from the right brain, from intuition, because everyone can do the obvious left brain sums. So we're skeptical of the bearish outlook and intuitively believe growth will continue and markets will rise. Money will go where it's treated the best, and stocks are in the sweet spot compared to bonds and cash. A little more inflation will be the icing on the cake. We think in a couple of years we'll look back at today's sweet spot for stocks as having been a time of exceptional opportunity—no matter the current negativism of those bleak, dismal scientists. No cake for you! Definitely no icing.

Herbert Abramson and
Randall Abramson, CFA
February 23, 2011

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