



RISK VS. RISK

One of our retired clients, a friend who just sold her house, recently asked us to drop her a note advising how she could have an investment that is low risk with a good return. Which today is every investor's desire, and dilemma. Especially anyone who suffered the extreme drawdown in the Panic of '08 and early '09 and who continues to suffer the dire forecasts.

Investing is risky, whether in stocks or bonds. That is, there is the potential for significant fluctuations which could result in capital loss if the investor's timeframe is abbreviated, or from other impairments, such as defaults, or poor corporate performance or simply the loss of purchasing power if the stock or bond returns don't keep up with inflation.

"Low-risk investing", in many ways today, may be an oxymoron. To be "low risk" would require short-term, near-cash, risk-free government or other high-grade, fixed income holdings. At today's rates, near zero, we don't believe those are "investments" per se, but merely parked cash waiting to be actually "invested". We do very little of that kind of activity. Nor, other than short-selling for accounts that wish it, do we do any "high-risk" investing, and indeed, though hypothetically, short-selling is only high risk inasmuch as stocks sold short could theoretically rise infinitely, our short-selling strategies are intended to diminish overall portfolio risk, but we capitulate to the hypothetical notion and designation nonetheless.

All we wish to invest in is "medium risk". This is what typically suits our client profiles and our attractiveness as their investment manager. And with the opportunity these days it's likely easier than you think.

Risk vs. Reward

Normally, we would claim that, like all other investors, we compare risk to reward. That is, we want lower risk investments compared to the larger reward they offer. And, as value investors, we have always believed and claimed that buying investments significantly below their fair market values diminishes the risk, with the prospect of their ultimately being re-priced to their fair market values offering the reward. We continue this philosophy, with the ability today to add undervalued larger-cap, safe dependable companies to the portfolios, an unusual opportunity that did not exist prior to the Panic, when we were driven to be more concentrated in undervalued small and mid-cap companies, where we perceived risk from their lower valuations to be less, accepting potentially more volatility, but never imagining that degree of it in the Panic.

Today, with interest rates at historic lows and investors terrified of equities, we think an exercise in comparing risk vs. risk among asset classes is worthwhile, ignoring for the moment any reward potential.

We know that a classic definition of investment risk is not just return *on* capital but return *of* capital, and clearly government bonds will return your capital on maturity. But what will you be able to get for the capital once it is returned is an important question. Sure, if you may need your funds in, say, two years, stay with risk-free treasuries, even at a record low 0.5% return, and avoid volatility. But why would any investor buy 5-year treasuries at 1.4%, 10-year treasuries at 2.6%, and, incredibly, 30-year treasuries at 3.6%, very poor returns on long-term investments, with great potential risk of loss of purchasing power, not to mention the loss of significantly better opportunities if one has that investment horizon? And especially for a taxable investor. Hey, if inflation were merely the normal 2% per year Fed target going forward, a taxable investor in long-term governments would likely suffer a capital loss and a loss of purchasing power over the next few years. And what if real interest rates were to rise materially in a normalizing and/or inflationary recovery? Some “risk-free” investment.

Stocks vs. Bonds

Indeed, from current insignificant after-tax, inflation-adjusted returns, we submit that long-term government bonds could be classed as speculations not investments, no matter received wisdom. And, especially with the risk of even higher inflation, threatened by potential monetary accommodation as contemplated in the recent Fed minutes. And really especially, compared to the alternative in the excellent values currently afforded in equities, even blue-chip, safe dependable equities—almost all with earnings yields (earnings as a percentage of share price) substantially higher than government bond yields and many even with regular dividend yields higher than bond yields. In fact, at 6%, the risk premium—the spread on the S&P 500 earnings yield over the 10-year treasury yield—is the widest gap in over 30 years, other than at the bottom in March '09. Yet, equities should enjoy growing earnings and dividends (especially from the record cash held by corporations) to allow for meaningful capital gains and improved dividend income while you wait for capital gains.

It has been argued that, if one takes a longer term horizon to smooth out the fluctuations, equities can be viewed as long-term bonds with an earnings yield in lieu of bond yield and often with a fixed dividend yield, mostly reliable, mostly growing. In the current environment if one takes, say, a 5-year time horizon to even allow for the possibility of an interim double-dip recession with a lower stock market from a poorer outlook for earnings, stocks should still be the preferred asset class in that extended period.

As professor Jeremy Siegel recently noted in a Wall Street Journal article, dividends have grown 5% per year since 1957. The S&P 500 dividend yield is 2.1% and, if they continued growing by 5%, from dividends alone the return would be about 2.3% annually over 5 years compared to the fixed 1.4% from 5-year government bonds. And that's apart from the potential for capital gains from stocks, with their preferred tax treatment, compared to the potential for capital losses from bonds. Notwithstanding, frightened investors continue to move money from stocks to bonds. Fear is stronger than greed.

History confirms that, with a total annual return over 10%, stocks handily outperformed bonds over the last 70 years, although long-term treasuries have beaten U.S. equities for the last 15 years. Of course, in the last 30 years we have had a significant bull market in bonds—we would argue it's now a bubble and about to end, the finale of the bull market in bonds which began in 1980-82 when 10-year treasuries yielded 16%. And, while stocks have languished over the last decade, especially the largest companies, on a mean reversion basis alone, they are the more desirable asset class. The Value Line Appreciation Potential Model, which has shown uncanny accuracy for over 40 years, currently projects a double-digit annualized 4-year return for U.S. stocks.

But we're not talking just reverting to the mean. We're also talking absolute cheapness. The P/E ratio on S&P 500 12-month forward earnings estimates is 11.7 making the market undervalued by about 25% today, with double-digit earnings growth expected through 2012. Three-quarters of S&P 500 companies are currently reporting positive earnings surprises, the fifth straight quarter of 70-percent-plus earnings beats. Profit warnings from S&P 500 companies in the past quarter were the lowest on record over the past 10 years. Corporations have a record \$2 trillion of cash on hand, almost 11% of assets, a 60-year high. For dividends, buybacks and acquisitions. And U.S. banks have over \$1 trillion of excess reserves on which they are getting 25 basis points. Itching to make real loans as demand improves. Like beauty, value and risk too are often in the eye of the beholder. Corporate insiders, among the most knowledgeable investors, are beholding the beauty and recently stepped up their buying. Equities. A handsome asset class indeed.

Stocks Lead

This from erudite Chief Investment Officer Bill Miller of Legg Mason:

“...the best investments are those with the worst previous returns, where expectations are low, demand is down, and prospects appear at best highly uncertain. In 1980 bonds had been through a 30-year bear market relative to stocks, inflation was soaring, yields were at historic highs, yet expected to go higher, and a long bull market in bonds was at hand. The idea that U.S. interest rates would be at all-time lows 30 years later would have been dismissed as ludicrous. The situation is now reversed, with stocks having underperformed bonds for decades.

The point here is simple: U.S. large capitalization stocks represent a once in a lifetime opportunity in my opinion to buy the best quality companies in the world at bargain prices. The last time they were this cheap relative to bonds was 1951.”

Of course the market is cheap because investors are fearful, believing that another economic dip is ahead, deflation is looming, unemployment will stay high, foreign economies will continue to tank and earnings will fail to materialize. Investors are understandably still in shock from the Panic in '08 and early '09, when stocks declined precipitously without the market being overvalued or monetary policy being tightened. Unpredictably. Human nature encourages us to extrapolate that the future will tend to be like the recent past. And again, fear is stronger than greed.

We're well aware that it is vital to take account of risk. We're well aware that investors need to look down before they look up—it's in keeping with a slogan Trapeze has used, "Higher Perspectives". We're well aware that Buffett says, "The first rule of investing is don't lose. And the second rule is, don't forget the first rule." Though even he lost considerably in the meltdown of the Panic when \$37 trillion of market value was lost globally, fast and furious. And, to add to our defensive strategies, in the next couple of weeks we will be seeking your authorization to use options from time to time to allow us, for example, to buy puts for some protection whenever we perceive a material decline.

Time Heals All

And while we're well aware of the current bearish forecasts, we tend to embrace the views of those economists who believe there will not be a double-dip recession, that the recovery will continue, though at an unusually shallow pace following a recession, but then pick up modestly later this year. The trade deficit grew in June to \$49.9 billion from higher imports and lower exports which will restrain GDP growth for now. July U.S. retail sales rose 0.4% (mainly autos). And, July U.S. industrial production was up too. Germany's Q2 economic growth, helped by the low Euro, was the fastest in 20 years, though Japan's growth moderated, hurt by the high Yen, while China's Leading Economic Indicators rose, forecasting improved growth, as China overtook Japan as the world's second-biggest economy.

Housing in the U.S. is the most affordable it has been in decades, and prices and activity are stabilizing. Autos are doing better—GM is preparing for its IPO. The consumer has the wherewithal to spend, with a savings rate of 6.4%, the highest in a year. Houses are still coveted, and consumers still need to eat, clean, educate children, insure, repair and replace worn out cars—you get it.

Corporate earnings are strong and balance sheets are too. Rail car shipments have been strong, and shippers, including UPS and FedEx, have been reporting strong volumes with better earnings and guidance. Industrial commodity prices have risen back to near record highs. The yield curve is positive and attractive. And credit defaults continue to lessen.

Productivity is historically high though the recent Q2 decline in U.S. nonfarm productivity suggests firms can't get more efficiency from their workforce (hours worked increased 3.6%) which is positive for employment and reduces the risk of deflation. While the July unemployment numbers were disappointing, the weakness came from losses in government jobs whereas private sector jobs actually rose a bit. As it should be. Moreover, even though that news disappointed, the markets barely reacted. "It's in the market." A stealth recovery.

Confidence From Markets

Over the medium term, stocks are the place to be, the safest place, risk vs. risk, all things considered, and with the best potential, risk vs. reward. Especially with anxious investors sitting on a mountain of cash, earning nothing. "Stocks are a screaming buy relative to bonds," says James Paulson, Chief Investment Strategist of giant investment manager, Wells Capital Management.

Indeed, if an investor with a moderate timeframe recognizes the undervaluation of equities, including some of the best known, safe dependable, blue chips with significant dividend returns, if appropriate given the personal circumstances, he or she could consider augmenting the anticipated capital gain return by borrowing a reasonable amount at low cost, tax deductible, margin interest. A time to be leveraged if there ever was one. While conventional wisdom suggests this is a time to be in cash, we would argue it may be a time to be modestly leveraged. Imagine, dividend payouts higher than the cost of margin, and higher than the 10-year treasury yield. Exxon, Intel, P&G, McDonalds, Coca Cola and Clorox with over 3% dividend yields. Pfizer, Dupont, Merck, Kraft and Chevron over 4%. 14 of the 30 DJIA stocks now yield over 4%, compared to the 10-year treasury's 2.6%. And, with record cash levels, corporations are likely to increase dividends (GE just did by 20%) and continue to buy back their shares to increase their share prices. Since January, 136 companies in the S&P 500 have increased or initiated dividends, with only 2 decreasing them. Private sector borrowing has shrunk in this recession for the first time since the Great Depression despite near zero interest rates from the Fed.

“Neither a borrower nor a lender be”, counseled Shakespeare, not imagining that these ultra-low interest rates would even have seduced Polonius. And also the many corporations, which don't even have a current need for borrowings, irresistibly “margin up”—IBM, McDonalds, Johnson & Johnson and Oracle, recently borrowing billions at the lowest interest rates on record for those corporate bond maturities (e.g., IBM, 1% for 3 years). BHP Billiton making a hostile takeover offer for PotashCorp for a record US\$40 billion, conspicuously using cheap borrowed cash, not its shares. Corporate borrowers with less than investment grade ratings have come to the party too, selling a weekly record of \$15.4 billion in junk bonds, as frustrated fixed income investors “chase yield”. Meanwhile, China's recent appetite for U.S. treasuries has been waning. Clearly a time for borrowing not lending.

Apart from the corrective pullback of the last several days, equity markets have recently been unusually strong, confounding the bearish pundits, because stocks discount the future and are telling us the future 6 months from now will be better. Indeed, higher equity prices may even support that prophecy inasmuch as they will give the consumer some much needed confidence. Just like investors, consumers have the cash, earning nothing, just not the confidence. Former Fed Chairman, Alan Greenspan, said in a recent interview, “...I've always believed, we underestimate the impact of stock prices on economic activity...I don't know where the stock market is going, but I will say this, that if it continues hotter, this will do more to stimulate the economy than anything we've been talking about....”

Being Contrary

Not always, but frequently, and often at extremes, it has paid an investor to be contrary. A consensus is usually a contrary indicator, and widely held views likely indicate what people have already done, rather than what the market may do. It worked in 1982 when bond yields were double digit and we said buy bonds, stocks don't work—and in 2000 when we were hugely short the tech bubble. Fed Chairman Ben Bernanke, in 1980 when he was teaching at Stanford, wrote, “The resolution of uncertainty...can lead to an investment boom.” Wouldn't the ultimate contrary surprise be a rip-roaring upside move in the stock market trapping all that cash on the sidelines? Which, of course, would tend to come in nearer the highs to extend the upmove. Latecomers. Shareholders would love it. Consumers would love it. Labour would love it. Obama would love it. Tax collectors would love it. Risk averse investors holding “risk-free” bonds would hate it. Risk vs. risk. And, remember inflation? What if mattresses start costing more than the cash to be stuffed in them?

Small-Cap Core Holdings

For our core smaller-cap companies where we have been concentrated, we believe that generally they are poised to move higher and we should be rewarded over the next 2-3 years with some outsized performance.

Corridor Resources, our clients' largest percentage portfolio weighting, has been struggling with recently reported disappointing cash flow from low natural gas prices and lower production. But the real story is the potential for a significant impact from its joint venture in its Frederick Brook Shale play where the operator, Apache, intends to complete 2 horizontal wells by year end. We expect successful wells with satisfactory flow rates and that Apache would then exercise its option to spend an additional \$100 million over the next 3 years to earn 50% in the property, including expanding pipeline capacity by the end of 2011. That would still leave Corridor with a massive potential, over 35 TCF of free gas in place. Apache is assuming a 30% recovery rate for the shale gas, but even using a 10% recovery rate, and almost nothing for the other assets, the risk-adjusted value of Corridor is 3 times its current share price. Another joint venture is currently doing a 3 well drilling program for oil on Anticosti Island, Quebec, where we should have results before the end of September. Then, of course, though somewhat delayed by the potential fallout from the BP fiasco, Corridor is still looking for a joint venture partner for Old Harry, its prospect in the Gulf of St. Lawrence with a potential for 2 billion barrels of oil recoverable, or a significant gas field. We also await the announcement of a new CEO to replace retiring Norm Miller, one of the founders, who was instrumental in creating all this exciting potential. Stay tuned.

St Andrew Goldfields just reported its third consecutive quarter of positive performance and is on target to meet its objective of producing 85,000 ounces of gold for 2010. It also completed financings of flow-through units and non-flow-through units (shares and warrants) for \$29 million of equity to advance its exploration programs, for capital expenditures and to prepay its 12% Secured Debentures (including a 10% participation fee for having achieved earnings targets) of which our income clients hold a significant amount. By year end it should have also commenced preproduction at its Holt Mine with a view to starting it in 2011. With 120 kilometers along the Porcupine Destor Fault, St Andrew is the largest landholder in the Timmins Mine Camp, the 3rd most prolific mining camp in the world. With an excellent balance sheet, meaningful cash flow from increasing production sheltered by significant tax pools and a now well funded ambitious exploration program, we believe the outlook for St Andrew over the next several years is unusually promising, especially since it still trades at a discount to its rising net asset value (supported by a rising gold price), while most in its peer group trade at premiums.

Orca Exploration has undertaken a rights issue of 1 new share for every 6 owned at \$3.90 per share, to raise some \$19 million, for which we intend to exercise our rights inasmuch as we believe the current net asset value of the shares is more than 2.5 times higher than that, and our 3-year target is \$14 for an annualized potential return over 50%. Use of proceeds is to fund a joint venture off the Italian coast, temporarily deferred following the BP spill from a moratorium on offshore drilling by the Italian government. In the meantime, as its gas sales and cash flow grow materially over the next several years, it intends to help finance infrastructure expansion, to allow it to increase gas through an expanded gas system. It is also actively intending to grow the company through the acquisition of a new oil exploration opportunity and intends to drill its Songo Songo West prospect in 2011. A well financed, very undervalued producer with significant growth potential.

Xcite Energy is commencing drilling on its UK North Sea property in September. We expect this high probability first production well—over 90% chance of success—will allow the company to book reserves and boost its net asset value to a level multiples over the current share price.

Large-Cap Stalwarts

A rare opportunity in what we believe are mispriced large-cap safe dependable stocks has allowed us to increase our weightings in this group to what we believe will allow us to achieve outsized returns over the next three years. Not quite as good as our smaller-cap favourites but nonetheless very attractive, especially as we trade off some potential reward for liquidity.

Clorox's results continue to meet our expectations. Unlike other branded consumer product companies, the company is demonstrating less price sensitivity to private label competition. Clorox trades at 14x next 12 months earnings (or a 7% free cash flow yield—the free cash flow as a percent of share price) and a 25% discount to its FMV. Its dividend, currently 3.4%, has grown every year since 1977 and by 10% per year since 2000. If the stock price simply remained unchanged, the growing dividend yield in 5 years ought to be 5%. The shares of this safe dependable are clearly a superior alternative to bonds, including Clorox's own 5-year bonds which yield only 2.3%.

We are forecasting a continuation of the company's 10% FMV growth rate and value the company at over \$80 today, growing to more than \$100 in two years—a two-year potential return of over 30% per year (including dividends).

Aflac also keeps producing consistent results. Its medical/health insurance operations in Japan, where it offers supplemental coverage to individuals above their employer or government insurance, are growing by more than 10% per year. Its current free cash yield is over 12% and the recently increased dividend provides a 2.6% yield, and with an overcapitalized balance sheet there is leeway for additional value to be added. At only 8x earnings and at 60% of FMV, *Aflac* offers a 2-year return potential well in excess of 30% annualized.

At *Kroger*, the largest pure grocer in the U.S., same-store sales picked up a bit in the most recent quarter. If, as we believe, food inflation is returning, that should ultimately translate into higher margins. The company trades for merely 11x earnings, or about 70% of its FMV. Its best-in-class management team should continue to drive growth. The recovery in its earnings, the dividend yield of 1.8% and a lift back to FMV combine to provide a 2-year annualized return potential of 30%.

Aetna suffered in '09 from pricing issues on its health insurance plans and from the general negative perception of Obamacare. Management decided to emphasize margins over plan enrolment, which has begun to pay off. Lower medical care costs across the whole HMO group have also helped profitability. Though the company does not pay a dividend, its 15% free cash yield makes it a standout, particularly in light of the margin enhancement plan that should drive earnings per share substantially higher over the next 2-3 years. *Aetna* trades around 60% of its FMV which, if achieved in the next 2 years, would give a 40% annualized return.

Jack in the Box continues to have poor sales results from the higher unemployment in its core states—Texas, California and Arizona. There has been some improvement and there is considerable leverage to earnings when sales begin to lift again. The exteriors of all stores have been remodeled and all company-owned locations will be refreshed by September of next year. The portion of franchised locations has now surpassed 50% of total stores which should help its return on capital. An activist shareholder recently announced a 5% equity stake. With an FMV 40% above today's share price and significant growth potential ahead, we foresee a 30% plus annualized return over the next couple of years.

Our only new addition to the portfolio is *Hewlett-Packard*. The controversy over the resignation of the CEO took the stock down to a floor in our work, to 8.4x earnings, 7.6x free cash flow (for a free cash yield of 13%) and about a 30% discount to FMV. The company essentially has no net debt and \$11 billion of annual free cash flow. Its profitability has been enhanced in recent years by a migration away from hardware to software. Most of the profits are now derived from its imaging and printing and services businesses. We expect the hardware refresh cycle to be robust helping push HP back up to FMV. If the company grows by 8% per year and trades at 12x earnings in 2 years we would get an annualized return in excess of 30%.

In our mandated bigger-cap accounts we continue to hold high quality companies that have rarely traded at such discounts to their ever-growing FMVs, and we anticipate high rates of return as prices climb back up to FMVs.

Income Holdings

Though, at current nominal government bond rates, fixed “income” ideas are oxymoronic, to say the least, we are endeavouring to find holdings for our income portfolios, often lesser known and less liquid names, but which we believe to be safe and able to provide a superior return for clients.

Our income accounts are now sitting on more cash than usual. We are actively seeking to reinvest the proceeds recently received from: (a) the early redemption of all of our 12% St Andrew debentures including a 10% bonus payment we received because its EBITDA exceeded the target; (b) the final payment on our BlueNote bonds from its asset sale proceeds; and (c) proceeds from recently selling some CompuCredit bonds as we trimmed our position when the bond price lifted over \$70. Then also, Uniserve resumed its preferred dividends on a monthly basis and will redeem 20% of the shares at year end at par value.

We still have not marked High River Gold or Specialty Foods higher, both having been marked down in the '08/09 Panic, although both are now clearly worth more than our current carrying values. We expect them to mature at their full par values at the end of 2011, and from our carrying values both have annualized yields-to-maturity in excess of 30%.

Bad News Is Good News

The Hays Advisory Service noted that its psychology composite recently reached an extreme negative point that has only occurred twice since 1990—in October of 2002 and between October to December 2008, both great stock market bottoms. Moreover, it points out the period soon to begin, in November of Year 2 of the U.S. Presidential Election cycle, “has a phenomenal historical record, with a median return of 16% (34.6% annualized)...there hasn’t been a negative return for one of these November to April periods since 1950.”

Ned Davis Research has found that the best stock market returns occur when consumer confidence is low. Typically, we suppose, when interest rates are relatively low and supportive of underowned equities, with lots of cash on the sidelines to fuel a rally. When there is no one left to sell. An improving economy will inevitably mean higher interest rates—perhaps, at some point, bad for stock holders, but surely worse for bond holders. Risk vs. risk. But, risk vs. reward, we might now have the best kind of equity market.

The various markets and sectors we follow are at or inflecting up from “floors”—buy points in our work. And, probabilities remain high that the markets rise significantly from here even if we have another temporary setback. Accordingly, we remain fully invested (even using some leverage in margin accounts) and continue to have no short positions, particularly with the prevailing low valuations. Climbing that wall of worry.

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August 23, 2010

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