SHORT SKIRTS AND SECOND SHOES

We are in an honest-to-goodness bull market which began at the Panic bottom in March '09 and we believe there is much more upside ahead. Possibly for years. Tops are made in euphoria—as when the Fed decides to remove the punchbowl from the party—to tighten money and raise interest rates. With the evident despondency today the Fed continues to bring on the punch—more liquidity, accommodative easing, to keep interest rates low and make credit readily available—for consumer spending, for housing and autos and apparel and necessaries, for government borrowings. And for stocks. We'll be swimming in punch.

At market tops corporate earnings growth is insipid, price-to-earnings ratios are high, corporations and consumers are overleveraged (à la the housing and credit bubbles we witnessed in '07) and investors are complacent.

At bottoms corporate earnings are inclined to grow, price-to-earnings ratios are relatively low, corporations and consumers are deleveraging and investors are cautious, if not outright fearful. Oh, and interest rates are low and the pent-up demand for equities is apparently high. All of which, to us, sounds like now. And, while all the technical experts look at the evidence that is tried and true for bulls—put-call ratios, investor sentiment, insider buying and the like—one indicator, which is often prevalent in nascent bulls and often overlooked, is that short skirts are back in vogue—an indicator, admittedly risqué, of better markets ahead, right up there with inverse head and shoulder formations and double bottoms.

Second Shoes

And if early bull markets tend to, and need to, climb a wall of worry, this one's a real worrywart. Everyone is worried about national and state debt levels, mortgage foreclosures, high unemployment levels, deflation, currency wars and most important, notwithstanding the economic recovery, albeit moderate, from the recession of '08, many pundits are fretting about a double-dip recession. And many pundits second-guessing Fed Chairman Ben Bernanke's plans to stimulate the economy with more monetary accommodation. All giving investors pause that the well-advertised concerns may cause a second shoe to drop. Better to stay in cash or in insignificantly yielding treasuries than risk the second shoe dropping. After all, second shoes could lead to lost shirts. But, in their atrophy, frightened investors are foregoing the rare and great buying opportunity clearly evidenced by the trend to shorter skirts.

We don't mean to be facetious and trivialize the investment process. Nor our obligation to protect and grow client wealth. But, we do indeed believe this bull market is the real thing—where an investor's savings will over time be treated the best. And that extraordinarily low yielding bonds are to be shunned. So we are fully invested, hardly short and focused on certain sectors and specific stocks.

We believe that the debt, deficit and default issues that currently dominate the news are finally being addressed—politicians typically only taking unpopular but necessary steps when they are forced to—as in a crisis. Bailouts. Deficit reduction. Fiscal reform. Discipline. Austerity. Castor oil—tough to swallow but healthy in the end. In the meantime, the likelihood of more inflation and currency debasement will benefit gold, commodities generally and stocks.

Yes, we do believe more inflation is coming from the monetary easing. Indeed, the Fed wants more, to encourage consumer spending and avoid the kind of deflationary malaise that has afflicted Japan for so many years. So commodity prices generally have been rising. Not just gold making all-time highs, but rising prices for silver, copper, other metals, oil, lumber, cotton and for coffee, sugar, grains and other foodstuffs. Likely a prelude to more inflation generally. Worldwide. Canadian CPI for October rose to 2.4%, higher than expected. China and India both recently raised interest rates to counter rising inflation. A lower U.S. dollar, while positive for exports, the U.S. trade deficit for September falling 5.3% to $44 billion (while Canada's neared a record as exports fell, mainly from its strong currency), is also a precursor of higher prices from higher import prices which in turn also allows domestic competitors to raise prices.

U.S. GDP grew at a 2.5% annual rate in Q3, more than expected, from higher exports and domestic spending. ISM manufacturing and services surveys showed that businesses grew in October faster than expected. Retail sales for October grew 1.2%, their strongest gain in seven months, double market expectations. Canadian retail sales rose too. U.S. unemployment is also improving, albeit slowly. The U.S. added 151,000 jobs in October, the first increase since May and more than twice the gain economists were expecting, though the unemployment rate remained high at 9.6%, and likely 200,000 more jobs are needed each month to reduce the rate. But, rising temporary help workers and manufacturing overtime hours hold promise for improved jobs growth. And jobless claims are falling, the lowest since July 2008. Stay tuned. Two important sectors for job creation, housing and autos, are strengthening. Existing U.S. home sales in October fell slightly from September to an annual rate of 4.4 million units, but were still up almost 8% from August. Mortgage delinquencies have declined for the past two quarters. House prices are starting to stabilize as the inventory of previously owned homes for sale fell in September, on their way to normal. And, as personal incomes are rising, housing remains about the most affordable it has ever been with lower house prices and the U.S. 30-year mortgage at 4.55%, and tax deductible to boot. Some second shoe.

The story of autos is better. Autos need to be replaced as the fleet ages, whereas houses gain character and merely need updates. Prices in the used-vehicle market in October reached the highest level since 1995, with used pickup trucks, a particularly good economic indicator, up 10% from a year ago.

Moreover domestic automakers have become much more productive and competitive globally. A lower U.S. dollar is also helping auto export sales and keeping them competitive with

imports. GM just posted a $2 billion Q3 profit, and is expecting a 2010 profit, its first full year profit since 2004, a result of lower operating costs, reduced sales incentives and improved North American markets—including an increase in truck production, again, usually a harbinger of an improving economy. And GM has just completed an oversubscribed IPO for $23 billion, the world's biggest, reducing the U.S. treasury's stake to 33% from 61%. Just prior to the IPO we bought GM preferreds and bonds, both of which are being exchanged for shares, because we see real value here. Remember, "As GM goes so goes America." Ford, which avoided bankruptcy, is doing better too, as are foreign automakers such as BMW. No second shoes here. Except on the pedal to the metal.

Short Skirts

The bull's best friend is corporate earnings. And when earnings are rising they're really best buddies. Stock appreciation is powered by an increase in profits, in growth. Q3 corporate earnings in the U.S. thus far have been doing great, with 76% of firms reporting better than expected earnings and almost 80% reporting positive year-over-year growth with net income up some 31%, and top line growth a healthy 8%. Corporate earnings are nearly back to their '07 highs. Total earnings for the S&P 500 are expected to have jumped over 40% in 2010 and a further 16% in 2011 giving a P/E ratio of 12.5x, leaving the market still undervalued by about 25% today. And double-digit earnings growth still expected through 2012.

The bull's biggest enemy is interest rates, but in the U.S. today they are historically the lowest, and now being kept low by an accommodative Fed, injecting another $600 billion of cash into the economy with its latest quantitative easing.

The strong earnings have come because companies have cut costs aggressively, keeping capacity utilization low and productivity high. Higher unemployment has, perversely, allowed this. Higher inflation for commodities generally has benefited some sectors too. Starbucks recently raised its prices and is aggressively expanding its store openings abroad.

Export demand should kick in, not only from a lower dollar but because the developing countries, such as China (now the world's second largest economy) and India, continue to grow at near double-digit rates, with strong retail sales.

Equity markets remain undervalued relative to their earnings and the prospect of growth for those earnings, and especially when compared to bond yields (see our last letter, "Risk vs. Risk"). And, importantly, the potential demand for equities remains high, from $11 trillion of nervous cash sidelined, earning next to nothing. U.S. corporations have over $2 trillion in cash. Investors are underweighted in equities, with hedge funds 15% underexposed, corporate pension funds 45% exposed compared to 69% in '07, and many advisors counselling increased bond investment. This, even while net buy-backs jumped 28% in Q3 and should continue to rise in '11 allowing the demand-supply balance for equities to continue to improve.

The total value globally of stocks has doubled to almost $52 trillion from its low of $26.6 trillion in February '09 with a three-month gain of $8.2 trillion from August-October, one of the largest three-month gains ever. September and October, normally weak months for the markets, were among the best in decades. And was especially good for our clients, our equity composites up double digits in each month.

Stock prices are a leading indicator and foretell of better economic times ahead. In fact, they are self-fulfilling inasmuch as better markets will give consumers and investors, and even corporations, the confidence needed to spend. So look for migration from cash and bonds to stocks, for improved capex, for rising dividends, rising M&A activity and corporate buybacks. Oh, and an extension of the tax cuts and a reduction in government spending, with pressure from a Republican Congress. And the well-known phenomenon of short skirts.

Trapeze—Back On TRAC™

No, it's not a spelling error. TRAC™ is an exciting new tool we have developed, which replaces the SVA™ methodology, to pinpoint buy and sell points of stocks we are following. And, we've also added a methodology called TRIM™, a market risk tool, that should alert us to psychologically driven panics as '08/'09, in order to become defensive and sell, sell short and, where authorized, hedge portfolios with put options. Strategies geared to minimize risk and maximize reward.

We are working hard to get back on "track" also and recover the losses from the Panic of '08. Not only with TRAC™ and TRIM™ but with some excellent analysts. These kinds of markets present a great opportunity not only to buy good cheap stocks but to find outstanding people not usually available. Analysts. Marketing people. And our new custodian, Fidelity, to allow greater flexibility. And an updated website (which more thoroughly describes TRAC™ and TRIM™).

We expect the markets to continue to recover. We believe the opportunity in large caps is unusual and we continue to look for more good names to add. Growing, important companies with excellent business franchises, good balance sheets, often paying dividends higher than 10-year treasury yields. Where we believe we can get 3-year total returns in excess of 20% per year. And our small caps, even cheaper, where we hope to get over 30% annually over 3 years, especially from material positive developments pending in many of our top smaller-cap holdings.

Vision To See What Others Overlook

This is our new slogan. Somewhat conceited, but we like to think we have some unusual insights, mainly by ignoring the noise and looking, in a common sense way, at likely outcomes, based on the facts, on history and human behaviour. All we want to do is own a piece of a good business that is temporarily undervalued from the inefficiencies caused by the noise.

Another, less conceited, slogan for our style could be, "Courage To Do What Others Fear." Really appropriate in these times. We're not afraid to focus on what we think are the best opportunities. Many money managers tend to diversify for diversification sake. Charlie Munger, Warren Buffett's long time sidekick at Berkshire Hathaway, claims that diversification is an admission of ignorance. We tend to agree, and want to focus on where our confidence is highest, where we think the undervaluations are the most pronounced and where the potential for our clients, on a risk-reward basis, is the most advantageous. We seek positive returns, not the market averages which over diversification will incline to.

So we have concentrated a good part of our growth portfolios in the energy sector, because we believe the demand for energy and its prices will be higher, especially in depressed natural gas names, because we think gas prices are bottoming as production inevitably declines and consumption rises. And, for most accounts, we are also now concentrated in four stocks comprising about half of client portfolios, Corridor Resources, St Andrew Goldfields, Xcite Energy and Orca Exploration. We've just added to Orca in a rights issue, some 20% below the current price, and some 60% below its net asset value. On the other hand, in most accounts, we've just trimmed a little Corridor as it rose above $7 per share and are trimming a little St Andrew as it has been one of our recent best performers, so both weightings needed to come down somewhat. The sale of neither, however, is a reflection on our positive outlook for those companies.

Small-Cap Holdings

Corridor Resources, even after we shrunk the position a bit, is still our largest percentage portfolio weighting. Despite declining production and low gas prices, Corridor is poised, we believe, for a near-term upside surprise from positive results from its two New Brunswick Frederick Brook shale wells now being drilled by its joint venture partner, Apache. Both horizontal wells have now been frac'd and completed, and will be tested with results likely in early January. If these tests are successful, with meaningful flow rates, this is a really big deal. Apache would be inclined to exercise its option to spend an additional $100 million over the next 3 years to earn a 50% interest in the subject lands. Corridor would also still have a significant amount of shale property not subject to the joint venture. These are very thick shales with an economy of scale potential and access to the best gas markets in North America making this a superior play. Corridor is also currently soliciting partners to drill an exploration well in Old Harry, a prospect in the Gulf of St. Lawrence with a potential 5 TCF of gas and/or 2 billion bbls of oil. And it is also looking for a partner for a shale oil exploration program on Anticosti Island where it has large acreage and limited early drilling had oil shows but no commercial success.

All of this prospectivity and our belief that natural gas prices should soon start to rise leading to higher spending and production. The reserves already discovered are worth about $4 per share. The Frederick Brook shale could add at least $12 per share to that over the next 3 years. That's a potential return in excess of 30% per year without including the value of anything else, which keeps Corridor a concentrated weighting.

St Andrew Goldfields has superior growth prospects with an excellent management team and a large land package. Q3 was profitable but slightly below expectations because of lower grades from its Hislop open pit mine. The grades, however, are expected to improve and production should increase to over 100,000 ounces next year. In the meantime, the company has an extensive drilling program under way and we are anticipating value to be added from exploration results from Smoke Deep and Deep Thunder at the Holloway mine and from the Taylor and Garrison projects.

The company has cash on hand, state-of-the-art infrastructure, generates free cash from increasing production sheltered by extensive tax pools, yet still trades below its net asset value—all in a buoyant gold market. We intend to sell about 10% of our managed account

holdings to reduce the overweighting modestly but we continue to be very optimistic on the outlook for St Andrew.

Orca Exploration remains significantly undervalued at about one-half of its current net asset value, has a strong balance sheet, particularly after a recent share rights issue (in which we participated) and enjoys rising production, cash flow and earnings. Production, currently at about 90 mmcf/d, could rise to 200 mmcf/d by '14 with additional infrastructure and success at its Songo Songo West field to be drilled later next year. And a potential exploration opportunity offshore Italy in due course. Given the undervaluation, expected growth and utility-like aspects of its business, Orca is a lower risk potential double to triple over the next 3 years.

Xcite Energy has lived up to its name. The company commenced drilling on its UK North Sea property last month and the initial indications from the pilot portion of the well appear to justify our base case expectation of a 900 million barrel pool of oil—over 200 million barrels potentially recoverable. Flow tests from the well are anticipated shortly which should allow the company's third party engineers to ultimately establish significant proven and probable reserves. The resulting net asset value would justify a triple from the current share price, even after its recent dramatic rise. We pruned this position recently but still hold an outsized stake.

We recognize that our smaller cap companies may not be the most liquid, but we have the "Courage" to trade off liquidity for value, for shares of businesses which can be more easily analyzed. Noted Yale University professor Roger Ibbotson's research indicates that thinly traded stocks tend to do better over time than their more actively traded cousins, because of their relative cheapness from the difficulty in buying or selling them for larger investors. "I want to buy as much of everything as possible for the lowest price," he says.

Moreover smaller companies are often underpriced merely because they are underfollowed, even generally unknown, the ultimate inefficiency. Small-cap stock prices today have become disconnected from their underlying fundamentals, a very compelling time to buy them. Remember, Apple, McDonald's and Barrick were once small-cap companies.

This will likely always be our bias. Nonetheless we seek to minimize risk by avoiding companies with leveraged balance sheets or with country risk. On the other hand, while smaller is sometimes better, we are currently growing our large-cap portfolio component which now comprises some growing world-class companies trading at uniquely relative undervaluations. The largest companies have now underperformed the overall index since the late-'90s bull market, indeed the smallest cap stocks in the S&P 500 have outperformed the biggest ones by almost four to one. We think this may be because their usual conservative, risk-averse constituency has fled this typically safe arena for the treasury market they perceive to be riskless. And because these companies were so overvalued from '99 to '03 allowing little, if any, potential gains for long-term buy-and-hold investors. But, imagine preferring a 10-year treasury at 2.9% over the best and biggest companies, many with free-cash-flow yields above 7%. Or buying, say, the 10-year bonds of Johnson & Johnson yielding 2.8% when the stock pays a dividend of 3.8% and trades at only 12x earnings. Imagine, dividend payouts higher even than the cost of margin. Wait until the tide reverses. It will look like the running of the bulls at Pamploma. The second shoe isn't about to drop, it's just on the other foot. We think it may turn out to be a glass slipper.

The economy will improve and an improving economy will drive interest rates higher. That could ultimately weigh on share prices depending on how high interest rates go, and is something we will need to continue to monitor closely.

Large-Cap Holdings

Our large-cap stock holdings remain undervalued too, at around 70% of Fair Market Value (FMV), while small caps are the cheapest, even though they have rebounded the most from the bottom, having detached the furthest from FMV in the Panic.

Hewlett-Packard trades at about 8x earnings (with a free cash yield of 13%), over a 30% discount to FMV. The whole tech hardware sector appears undervalued and, in aggregate, is "on buy" in our TRAC™ work. As the global economy recovers and corporate capital spending levels increase, we expect HP's share price to get back to its FMV. A mere 8% per year growth rate and a 12x earnings multiple, in 2 years, provides for a potential return in excess of 30% per year.

Aetna is still dealing with the uncertainty surrounding Obamacare and from its own '09 pricing issues. The company has a margin recovery plan which is already in the early stages of paying off. And, we are witnessing lower medical care costs across the HMO group in general. Aetna trades at only 9x earnings. We expect earnings per share growth to accelerate over the next 2-3 years. Yet, Aetna trades around a 40% discount to its FMV which, if relieved in the next 2 years, should provide a 40% annualized return.

Though *Aflac's* results have continued to meet our expectations and it has high potential return prospects, we nevertheless lowered our weighting recently as the company gave a TRAC™ sell signal. Similarly, we trimmed *Jack in the Box* when it gave a TRAC™ sell signal and *Goldman Sachs* too as it rose closer to its FMV.

We have added two new positions, *General Motors* and *Cisco Systems*. GM is an unusual opportunity to invest in a cyclical company at a trough multiple with earnings also at a trough—normally, at the bottom of a cycle, earnings would be low but the multiple would be high. In GM's case, its bankruptcy allowed it to rid itself of debt, lower operating expenses and enhance overall efficiency. This has led to solid profitability even while overall vehicle sales levels in the U.S. have yet to recover. GM is excelling in China where it is the number one vendor. When we deduct the net cash and other non-auto assets, investing in GM gets us the auto company assets at around 3.5x EBITDA, a very low multiple. Trading just above the IPO price GM is selling for nearly a 25% discount to FMV, which should rise dramatically over the next couple of years, offering 30% per year appreciation potential. We jumped the gun and bought the preferred shares and, for RSPs the bonds, which pay no dividends or interest but are exchangeable for common shares—there's a predetermined exchange ratio from the restructuring and we receive our shares in the next 90 days. We did anticipate a more material lift in the share price on the IPO and believed getting access to the IPO shares would be difficult. However, the government responded to the demand for shares by selling more of its stake, limiting the initial post IPO jump. Meanwhile, the flippers will flip, the earnings should continue to rise and, at some point over the next several months, GM will almost certainly be included in the indexes again causing a lift in price from benchmark-driven indexers and ETFs forced to buy.

Cisco was purchased just after it disappointed with its earnings release. At about 12x earnings (10x net of its cash hoard) and a 30% discount to FMV, the company appears too cheap to pass up. Cisco continues to dominate its field, though sales to spending-restrained state governments held back recent top and bottom line figures. The company is still expected to grow overall profits by double digits as continued internet traffic growth, including from emerging markets (where sales were up over 30% in the quarter), will increase the demand for better routers and switches. A mere 8% growth rate, combined with a climb back to its FMV near 17x earnings, would lead to a 30% annualized two-year return.

In our mandated bigger-cap accounts we continue to hold several other high quality companies that have rarely traded at such discounts to their growing FMVs, and we anticipate meaningful rates of return as prices climb back up to FMVs. Many stocks we follow have returned to FMV—a sign that bodes well for their peers. And very few stocks appear to have overshot yet.

During the quarter we eliminated our Canadian Phoenix holdings after it sold all key assets and the stock rose to FMV. We also sold our Etruscan position as it was being acquired by Endeavour. And we eliminated our Sterling position on strength, preferring our stake in Xcite, another North Sea player.

Clients who formerly held Pan-Ocean Energy shares, just received $.802 per share from the company that had been escrowed since the company was acquired in '06.

Income Accounts

Though at current nominal government bond rates the term fixed “income” is oxymoronic to say the least, we are still finding acceptable holdings for our income portfolios, often lesser known and less liquid names, but which we believe offer better risk-adjusted returns for clients.

We have begun to redeploy the cash received in the last few months in our income accounts, buying additional *Dynacor Gold* debentures yielding 15% to December '11, *LDK Solar* bonds which are puttable by us in April of next year (the yield-to-put at purchase was about 9.3%) and *Ticketmaster* bonds which yield 7%-8% (depending on when the bonds are called) until 2012-2016. All are strong businesses. Dynacor needed short-term funds to assist with its growth plans, which have already paid off with a stellar quarterly result and, we expect, more to follow. LDK received a material investment from the Chinese government, assuring the company’s ability to deal with its puttable bonds next year. Ticketmaster is a high quality business whose bonds provide a much higher yield than other similar quality bonds.

We were also able to price both *High River Gold* and *Specialty Foods* bonds back up after being marked down in the '08/'09 Panic. High River traded significantly at $89 and Specialty Foods bought back about $19 million in bonds in a Dutch auction at $99 (and has since made a tender offer for the balance of its bonds). We expect High River to mature at its full par value at the end of '11. And Specialty Foods will have enough cash to at least retire its bonds at par but they should be worth much more from the conversion privilege.

Stocks Outperform

The key North American stock indexes are still "on buy" in our TRAC™ work. They've inflected up from lower boundaries and appear to be headed higher toward upper boundaries and their FMVs.

Also, from a short-term perspective, every time the market pulls back, the worrywarts pull back too. Last week, in the midst of a pullback from the noise of Ireland, even as the market got technically oversold, net outflows from equity mutual funds and ETFs eclipsed $4 billion, a buy indicator in a bull market. And, as we have previously noted, the market is now in a sweet spot inasmuch as from November of the second year of a U.S. Presidential election cycle, the median return to April of the following year is 16%, with no single negative return for these periods since 1950.

Wharton Professor Jeremy Siegel's research demonstrates that there has never been a long period when stocks didn't outperform cash, bonds and inflation and argues that most people of average risk tolerance should have roughly 100% of their capital in the stock market. We subscribe to that notion generally, as clearly it is dependent on a particular client's objectives, time horizon and temperament. At this moment in history, where many investors fear stocks, the relative opportunity to get significant free-cash yields (cash earnings not currently required for business operations) compared to alternative investments is obvious. For example, T-Bills and GICs/CDs offer merely basis points. 10-year government bonds about 3%. High grade corporate bonds about 4.5%. High yielding corporate bonds about 7%. Whereas the shares of blue chip companies such as Hewlett-Packard, Aetna and Cisco currently all enjoy free-cash yields of over 10%. Growing as well. And subject to the more favourable capital gains tax rates.

The advantage of stocks over other asset classes is particularly acute today. This bull market is still in an early stage. We think it will have legs. And that shorter skirts will ultimately reveal them.

Herbert Abramson and
Randall Abramson, CFA
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