STAYING BULLISH

Even as the stock market has improved this year, from record corporate earnings and modestly improved economic growth in the U.S. and Canada, risk aversion among investors generally remains high. Understandable, with the relentless scary headlines from Europe. Spain and Portugal looking to follow Greece. Spain and Britain back in recession. A new socialist government in France opposed to austerity. A slowing Chinese economy. The Bush tax cuts about to end making dividends and capital gains less attractive. Uncertainty in the Middle East and the issue of a nuclear Iran. Rising gas prices. Heightened polarized rhetoric in an election year. Concern that the rate of corporate earnings growth may be slowing from peaking profit margins. The potential for no QE3 monetary easing from the U.S. Fed. And a somewhat overbought stock market which was in need of a normal correction. Oh, and the potential for a "Black Swan", an unpredictable calamity, for already fearful investors.

Well, we believe we are in a new bull market, and bull markets thrive on climbing that proverbial wall of worry. Bullish sentiment is low and bearish sentiment high. Anxious retail investors, having suffered two ugly bear markets since 2000, continue to shun stocks, with money flowing out of mutual equity funds now for more than 5 consecutive years. The public is hugely underinvested. Cash on the sidelines is enormous. The fuel to ultimately power stocks higher as confidence returns.

Headwinds Abating

And, we feel confidence will return. A rising market in itself will bring more confidence, not merely to invest in stocks but to spend on cars, housing and at retail generally. Indeed, consumer confidence continues to improve, and their debt levels too. Private sector wages are improving, to drive spending. The index of leading economic indicators is at the highest level since June '08. U.S. retail sales grew again in March. U.S. pending home sales rose to a nearly two-year high in March. The U.S. April ISM manufacturing index was the best in 10 months, implying better growth. So while the news ain't great, it's getting better. Headwinds are abating. While growth is normally stronger coming out of a severe recession, we're nonetheless seeing growth. Low inventories are being rebuilt. U.S. unemployment while disappointing at 8.1% is declining moderately, though Canadian unemployment improved to 7.2%. The Canadian budget deficit is declining and could be balanced in a couple of years. Canadian business optimism is high, looking to a substantial recovery, and the Bank of Canada raised its forecast for 2012 GDP, though based on February's contraction the annualized growth rate slowed. While U.S. GDP in Q1 declined to 2.2% the drop came from lower government spending. But private sector spending growth and a lower U.S. trade deficit should help GDP growth. As growth continues and productivity declines unemployment should improve. U.S. housing continues to be exceedingly affordable and should improve too as anxious renters and mortgage lenders gain confidence too. The inventory of homes for sale has declined to 6.3 months. Furthermore, the U.S. auto fleet is almost 11 years old and will need replacing.

Chinese manufacturing grew in April, its domestic consumption is growing big time and wages there are rising. That should translate into more demand for commodities. China and India with still strong but slowing growth are in stimulative mode to compensate for tougher export markets. India just lowered interest rates for the first time in three years to spur growth. And while Europe is in recession with 10.9% unemployment, serious issues of rising deficits, fiscal and banking crises, potential sovereign defaults and the very existence of the Euro in question, the mere fact that the malignant debt and deficit issues there, and domestically here as well, have been diagnosed has, of necessity, forced painful measures for a recovery. Austerity is unpopular and creates unrest. But reality requires change, even for reluctant left wing governments. Interestingly, German manufacturing output in March was higher than expected from demand outside the Eurozone, German investor confidence beat expectations, demand for Spanish debt was better than expected and European stocks are higher year to date. The price of the Euro currency holds up remarkably well. Sure, the situation in Europe could worsen, with the potential for negative impact on the market. And we remain alert to react to economic dislocations that could have an outsized impact. But we believe with the market so focussed on the negative headlines, it is likely already accounting for those negative possibilities. The worst may be behind us. And if it takes a little longer than we think it should, we feel confident that our holdings will sustain the wait and be well-positioned for an upturn.

Tailwinds Ahead

The headwinds seem to be abating, albeit slowly, but strength should build on strength and ultimately become tailwinds. U.S. demographics, the population growing by 3 million annually, augur for greater demand and growth. U.S. banks are relatively healthy. Even as government debt worsens, since '09 private debt-to-GDP has fallen. A better housing market will help the economy. And while there may be no QE3 we are assured that treasury rates in the U.S. will continue near zero until late 2014. The growth of domestic shale oil and shale gas will ultimately make the U.S. less dependent on foreign oil. Tailwinds. The stock market itself is a leading indicator and the strength of the U.S. markets since last fall implies better days ahead. And a rising market boosts confidence and, of course, wealth. A tailwind too.

Renowned money manager Ken Fisher, in the recent issue of Forbes, notes that, in the late 1980s crash, net interest payments on the debt of the troubled countries as a percent of GDP were twice today’s levels. Housing plummeted and banks were failing. Europe was in a recession and a global downturn was being predicted. Then, 1993 ushered in a new era and market perspective. We also see the similarities and think there will be a similar outcome.

Stocks—The Best Game In Town

What is it that investors seek? Clearly they wish a return *on* invested capital and a return *of* invested capital. If from fixed income investments, a safe return is one from a creditworthy lender higher than the rate of inflation, i.e. a real return. If from equities, they wish to be in companies whose debt levels are low and/or manageable and whose revenues, earnings and free cash flow are growing and likely to continue to grow in the future, and where the price of the stock is cheap relative to its Fair Market Value (FMV), which we believe allows for downside protection and meaningful upside potential. A dividend return or possibility of dividend return is also meaningful. Needless to say, because the prices of equities fluctuate, an equity investor has to have an appropriate investment time horizon. And, of course, stock returns need to be able to compete with available real fixed income returns.

Because the problems in Europe are so publicized we believe the issues are being discounted, i.e. they are "in the market". They account for why interest rates are so low and why Central Banks so accommodative. Why we believe money printing and bailouts may continue to be the order of the day. Why equity investors are so fearful, why cash on the sidelines is so excessive, why cash on hand of corporations is so high and why businesses are being operated so efficiently that U.S. corporate earnings are at record levels. And why equities are at attractive levels.

Today, stocks are the best game in town, at less than 13x earnings for the S&P 500, below their longer term average, the cheapest relative to bonds since 1974. Treasuries, with only nominal returns and the likelihood of rising inflation, are risky and no place to hide. On the other hand, rising inflation will lessen government debt burdens. Good for the borrower, but great risk for the lender. Importantly, corporate earnings generally continue to beat expectations—Alcoa, Google, JP Morgan, Goldman Sachs, Citigroup, Microsoft, Coca-Cola and Apple, for example. With S&P 500 corporate earnings at record levels and at its current P/E ratio, its earnings yield is near 8%, and, with respectable and rising dividends to boot, stocks are a much better alternative to 10-year treasuries yielding less than 2%. In fact, the past trading day was only the 17th trading session in the last 30 years where the S&P 500 dividend was higher than the 10-year treasury. Corporate balance sheets are strong, allowing for expansion, dividend hikes and corporate buybacks to support share prices.

Bottom up, stocks are reasonably priced but, we believe, especially cheap in the groups and the holdings we own.

Investing in businesses is inherently risky. Macro risks, as we have seen, can affect stock markets and particular sectors. Individual investments are subject to their own particular risks. Businesses are subject to competition, regulation, politics and economic cycles, amongst other things. Then, of course, public companies fluctuate in price. In the short term, stocks can move in an unwarranted fashion based on market sentiment creating declines for owners, opportunities for prospective buyers. But over the longer term, given the market prices of our holdings compared to our much higher appraisals, we believe we have a wide margin for error in our positions. That's not to say we won't have losers but based on our wide valuation discrepancies we believe, overall, the odds are in our favour.

More Inflation Coming

Stocks should shine relative to other asset classes, particularly bonds, especially if, as we believe, higher inflation is in the cards. From rising commodity prices, labour costs, improving pricing power and especially from continued money printing as central banks need to buy government debt for the foreseeable future. Last year the Fed bought 61% of U.S. government debt. The U.S. national debt now equals its GDP and may be up by another trillion dollars this year. $5.9 trillion of U.S. debt is coming due in the next 5 years, presenting inflation risk from the Fed needing to purchase the rollover debt. Reflating depressed economies is the order of the day. But reflation typically means inflation. Inflation is bad for bonds, but, initially, good for stocks. Rising inventories and pricing power. Very importantly, a big incentive to buy houses as their prices rise.

A lower U.S. dollar (the recent go-to “risk-off” currency) would be the icing on the cake. While it would help exports and the earnings of multinationals, it would also increase inflation from higher import prices. And don’t think the Fed doesn’t want a lower dollar, to stimulate exports and avoid deflation. As does the Bank of Canada with regard to the loonie. And all other Central Banks as to their own currencies.

Focus On Bottom Up

Back to bottom up. What should now be the real focus? For us, as value investors, it’s that investor concerns have made the comparative valuations of stocks “inefficient”, i.e. created an extreme disparity of valuations between groups. In particular, Canadian smaller capitalized stocks are now much cheaper than their larger cap brethren. The TSX Venture Exchange is still 60% below its '07 high. An unusual opportunity, though the smaller cap companies clearly present greater risk in terms of their volatility and liquidity. In our portfolios most of the stocks trade well below our appraised value. A disconnect which is frustrating in the short run, but which we believe should inevitably provide gratification.

We are continuing to emphasize the energy sector, with the oil stocks we own very attractive, even assuming somewhat lower oil prices. Natural gas may finally have bottomed and has been moving higher. The gold sector is also attractive, with depressed share prices even with bullion at $1640. Both those sectors are very oversold and should start to outperform.

We always hear the notion that just because stocks are cheap doesn’t mean they will rebound any time soon. All those concerns: economic problems will overwhelm them; buyers don’t care (particularly if they’re small caps); and it will be a long time before we will see any material recovery. We disagree. First, as we’ve noted, the economic headwinds seem to be abating—our econometric model shows no sign of recession. The highly favourable monetary and valuation conditions should lift the markets and act as downside shock absorbers. Our own proprietary market tools show green lights too. Even though they have corrected, the markets remain “on Buy” in our TRAC™ work. Our TRIM™ work, which we use to perceive bear market moves, has not flashed red, although the S&P 500 recently rose to a stretched 20% above the TRIM™ line suggesting a pullback or perhaps a few months of sideways action.

Stocks normally track their underlying values rather closely and most stocks today (the big cap biased S&P 500 and the small cap Canadian stocks being exceptions) are close to fair value at around 16x earnings. Our own holdings are a mix of cheap larger caps that are anomalously mispriced and smaller caps that have remained far below our estimate of fair value but are well up off their lows. The smaller caps have greater potential upside though tend to be more volatile and less liquid.

Our Top Holdings

Our view is that the companies we own are so far below fair value that, as they continue to add value, they will be difficult for investors to ignore. For example, if in 3 years' time, Manitok, our largest position has, as we forecast, annual cash flow per share exceeding today's share price, it is highly unlikely its share price won't reflect reality.

Manitok Energy, clearly undervalued, trades at less than half of our appraised value—a value one can easily derive from a cash flow analysis, a net asset value based approach or a private market valuation (what an acquirer would pay for the entire entity).

We value the company today in excess of $3 per share, over twice its share price of $1.40. It just guided to a year-end exit rate of $55 million of cash flow or $.90 per share on approximately 4,000 bbl/d of production which should value it over $4 per share later this year. And then, based on only its existing land holdings, the company is in a position to more than double its production and cash flow over the next 2 years boosting value much further.

So what do we see that others don't? Well, in the case of Manitok, others may not have seen it at all—the company only came public in late 2010. And it's a small cap with a market cap of just under $90 million so many institutions might not participate until it is larger because they cannot easily establish a meaningful position. It is the only company participating in its core area and therefore there are no familiar comparables. And, because it's newer, some may want to see a longer track record prior to investing. Some may not like its high proportion of gas in its booked reserves, though the company expects to be over 60% oil and liquids by year end.

We think our analysis allowed us the advantage of being early—being able to establish a meaningful position at a significant undervaluation. We are indeed attracted to the price discrepancy but mostly to the attributes of the underlying business. Manitok has competitive advantages—an experienced team, mostly former Talisman employees who operated in this locale (the Foothills of Central Alberta) for many years. The economics of cheap land prices and long-life reserves make for very attractive IRRs (internal rates of return) on its mostly oil focused development drilling. Solid value today, and as the company continues to drill one well per month for the next few years, the underlying value should continue to compound and other investors will eventually notice. And, if they don't, some bargain hunting energy company could bid for it.

Obviously a key risk for Manitok and our other energy holdings is the oil price which, despite growing world demand for energy, could temporarily dip in this unsettled world. We conservatively use only $85 oil (with the industry marginal cost of production above $90) and $2 gas in our analysis. But, we believe being overweight the energy sector is currently warranted because, having performed so poorly, it is the least expensive group, offering a plethora of solid growth companies at extreme discounts to our estimated fair value. Besides Manitok, our top holdings also include Orca Exploration, Southern Pacific Resources, Legacy Oil + Gas and Corridor Resources.

Orca Exploration produces natural gas for power, mostly at regulated prices to the Tanzanian power utility, but also to local industrial users at market prices. Orca's gas is in high demand given the serious power shortages in Tanzania.

Orca trades at an extreme discount—at about one-third of our appraised fair value—for a few reasons. A company with operations in Tanzania may be avoided by some investors fearing political risks. The market cap is also small, just over $110 million, and trading volumes typically low. Its earnings progress has been slower than expected. Moreover, since late last year the company has been dealing with a report alleging irregularities issued by a special parliamentary committee in Tanzania. Orca is addressing these issues and we believe its effects are likely to dissipate in the near term.

Meanwhile, the government has signed an agreement with a Chinese sponsored group to build a major pipeline (to be completed in late 2013) and 3 major oil companies have made multi-Tcf discoveries in the region, so the government's long-term plans for enhanced gas-fired power generation are finally being placed in motion. Orca's production and cash flows are already at record levels and the pipeline will allow a ramp-up of production.

The current reserves alone produce a valuation at least twice the share price. With drilling ongoing at Songo Songo to increase potential production and then a proposed high potential exploratory well at Songo Songo West later this year, plus exploration drilling in Italy soon too, the net asset value could rise even further.

Orca has long-life reserves, operates at low costs with high netbacks and Orca's infrastructure, contracts and headstart could have appeal to the majors in the region. We anticipate Orca may be monetized in the next couple of years for more than twice its current share price, perhaps much more depending on drilling success in Songo Songo West later this year.

Southern Pacific Resources ("STP"), while not small, is a relative newcomer, and lesser known. Its core asset is McKay, an in-situ oil sands project in the Athabasca region of Alberta. STP's current production at its Senlac project is about 4,500 barrels per day generating cash flow which advances the larger McKay project. While it's not producing from McKay yet, which may cause some investors to wait-and-see, the first phase of development is fully permitted and funded, with construction nearly complete and under budget. The initial 12 SAGD well pairs all encountered high quality reservoir.

We also have high confidence in the quality of the reservoir given the location of the McKay Project, approximately 45 km northwest of Fort McMurray near the Suncor McKay River SAGD project which began producing oil in 2002 and today produces approximately 30,000 barrels per day of bitumen. Suncor's success has led to an expansion. STP's acreage also happens to be contiguous with Athabasca Oil Sands' McKay River project, for which PetroChina paid $680 million for a 40% stake, scheduled to begin producing 35,000 barrels a day by 2014.

Adding the value of STP's McKay project, where 10,000 barrels per day come onstream in the fall, to the value of the existing Senlac production, we calculate total net asset value at over 3 times the current share price, again using only $85 oil. While the debt level is higher than preferred, we expect that cash flow from the value of the existing production alone could retire the debt in an acceptable time frame.

STP's third party engineers have ascribed $1.7 billion of value to its proven and probable reserves. In the near-term McKay will almost quadruple STP's production by the end of this year or early next. Using a discounted cash flow analysis, STP could potentially be valued at about $7 per share ($1.60 price today) over the next 3 years, a significant upside.

Legacy Oil + Gas is a new addition for us. The company is a light-oil focussed intermediate producer with assets in Alberta, Saskatchewan and North Dakota. After running up ahead of its fair value, the company fell 40% in the past year in the recent energy group correction. Other than concern about lower oil prices we know of no reason for the current undervaluation. Over 85% of Legacy's production is light oil, so there's no issue of natural gas exposure. Legacy has a larger market cap of around $1.2 billion and is flowing about 16,000 boe/d. It drilled over 90 wells last year with a 100% success rate. Costs are coming down and the wells have been delivering way ahead of the expected type curve. There are no operational concerns, and the company's leverage is not out of line either.

We believe its price decline is unwarranted. We currently appraise Legacy at $12 per share, so at $8 it's about a 70 cent dollar and growing by over 25% per year as it taps into its 1,200 net drilling locations. Even at $85 oil, we anticipate our appraisal may rise to $25 or more in 3 years—a target which would provide more than a 40% annual return.

Also in the energy sector we sold ***Xcite Energy*** to make room for Legacy and ***Vero Energy***, plus in our larger cap mandate accounts, ***Apache***—the latter two trading at about 60 cents on the dollar with fast growing FMVs.

St Andrew's share price performance has been disappointing, especially in relation to the recent ongoing solid performance of the company. St Andrew's production has returned to forecast levels and production costs are lower. Yet the trading price remains well below the net asset value, now even at book value, partly because of disappointing performance in the first half of last year but mainly, we think, because gold stocks generally have corrected substantially.

The downside risk would be from a decline in the price of gold. The company should produce about 100,000 ounces in 2012 with further growth ahead. Cash flow this year should be about $50 million, more next year when its gold loan will be gone, and from expected higher production. We still have an upside target of $1.60 in 3 years (assuming even a lower gold price of $1400, at an 8x cash flow multiple). Four times the current share price. At the current price of gold, based on our productions estimates St Andrew could have as much cash in 3 years as today's share price, so we'd be getting the entire mining operations and other assets free. Not to mention potential resource growth from ongoing exploration on its vast acreage.

Dell remains mispriced, in our view, still misperceived as a consumer PC purveyor, though very little of its profits are derived from that line of business. The recent lift in fair market value occurred as the company transitioned its business to servers, services and software, however the market has yet to embrace it. And, the cash on the balance sheet obfuscates the true value. On the face of it Dell appears to trade at 8x stated earnings. However, one needs to account for its excess cash, and the ongoing free cash flow from working capital that boosts true earnings.

Dell free cash flows over $4 billion annually, constantly adding to its current $9 billion net cash reserves. At less than 5x free cash flow, the company would have net cash exceeding its current share price in just over 4 years.

With our estimated FMV in the mid to high $20s, we own one of the top global brands at about 60 cents on the dollar. The company's competitive advantage is its status as a low cost producer in servers, its core product. Growth should pick up in the second half of the year, with the arrival of Windows 8, from upgrades at the enterprise level.

Meanwhile, the company's growth strategy is working as it acquires and delivers. An increase in valuation to 10x free cash flow, plus its cash, and the growth we anticipate, has the potential to raise the share price by over 30% per year over the next couple of years.

Pivot Acquisition, a private IT outsourcing company, in which we own convertible debentures just paid 10% extra interest for not having met its initial IPO timeline. We have now collected 22% (including the 12% coupon) in the 12 months we've owned it. Overall debt and interest expense are well covered. As a private company Pivot's securities are not listed, so the debentures are subject to liquidity risk, which we believe is somewhat compensated for by the premium yield and conversion privilege. Although we are disappointed that Pivot hasn't yet done its public offering, it still intends to either go public or raise additional capital in the next 12 months, so the debenture holders stand to gain from the conversion privilege.

Pivot was established to acquire other similar IT companies to enhance margins via corporate costs leverage and to generate a higher margin from emphasizing services. Its budget for this year is $50 million of EBITDA without further acquisitions. We assume a 5x EV/EBITDA multiple from an IPO valuation, making Pivot's total enterprise value $250 million. The debenture's equity conversion price is 50% of its IPO (if and when it occurs) price, which would provide a large potential lift over our existing carrying value of par for the bonds, plus, of course, we get its 12% coupon while we wait.

Specialty Foods, also a private company, is the manufacturer of Nathan's Famous hot dogs, the leading hot dog brand in the U.S., along with other packaged meats. In the first quarter the company matured all of the convertible debt and we rolled our U.S. debentures into a new 8% non-convertible debenture plus warrants which can be exercised into equity. As a private company, these securities have the same risks of valuation (since a market price is not readily available) and liquidity as noted for Pivot, above.

We believe the warrants are worth much more than our carrying value because our appraisal of the company greatly exceeds the debt. Based on the company's annual free cash flow of $10-$15 million per year, over the next 2 years, we estimate that the total value of the bonds and warrants could be as much as 30% higher than our current total carrying value. Meanwhile its free cash flow should retire the debt in just over 2 years and the debenture is to be repaid in 3 equal annual increments beginning this June. If Specialty is able to extend its contract with Nathan's (the existing contract expires in March of 2014) the value of the debentures/warrants will be substantially higher than our carrying value. Without the Nathan's renewal our appraisal is still about $150 (our carrying value is $115 today combining the debenture and warrants). The value could be higher with a Nathan's license renewal.

Corridor Resources is essentially in a holding state until natural gas prices recover or it lands a partner for one of its 3 mega projects, two of which are oil.

With oil having hit a record 50 times the depressed price of natural gas, few companies are allocating capital to gas projects which should lead to dwindling gas supplies in due course. Gluts beget scarcities. The number of dedicated gas drilling rigs in the U.S. has dropped from over 1600 in 2007 to just over 600. Utilities switching from oil and coal to gas has picked up. Demand should also lift from a growing economy and various initiatives like using compressed natural gas for transportation and the construction of LNG facilities to export gas to foreign markets where gas prices are dramatically higher.

Corridor is still seeking partners for its three projects. Its massive Frederick Brook shale gas area, which has 59 Tcf gas in place and for which the company's 2011 appraisal well showed extremely promising results with gas shows in 8 separate zones over nearly 1000 metres of depth. Its Anticosti Island, Quebec, shale oil project, with 19.8 billion barrels of oil equivalent resources in place. And its Old Harry project in the Gulf of St. Lawrence, with potentially 2 billion barrels of oil recoverable. Each one of these projects has potential to have a positive impact on Corridor's current share price.

Meanwhile, the company's proven and probable reserves, infrastructure and land value alone constitute over twice the current share price. Corridor is debt free and estimates a year-end working capital position of $12 million.

We remain invested in the company because our view of the risk-adjusted net asset value is still well above the current price. Whenever gas prices recover we should see a meaningful rebound in Corridor. Although gas prices seem to be bottoming, the timeline for that is uncertain, but the longer term risk-reward ratio is still very favourable.

Fortress Paper has gone from stock market darling to an object of skepticism. The company is in the midst of a transformative event, the conversion of an old NBHK pulp mill in Thurso, Quebec to a dissolving pulp mill. The conversion and ramp has experienced some delays, but nothing out of the ordinary for such a large scale engineering project. Fortress announced that full production capacity of the premium-priced dissolving pulp mill should be reached by the middle of this year. Dissolving pulp prices, which declined from unsustainable levels (though only a perceived risk because they are hedged for several years), have now stabilized in a range that should generate significant cash flow and profit in the second half of 2012 and beyond.

Fortress' banknote and security paper division in Switzerland suffered over the course of the past year in the European crisis. However, management's view is that orders were merely postponed and they are confident that the mill will be at full capacity in the second quarter of this year.

Meanwhile, the specialty wallpaper plant in Germany is operating at record levels, throwing off approximately $30 million of cash flow per year. We understand that management received inquiries regarding the sale of the division in the past, which we believe could materialize again. In any event, the cash flow today provides a solid buffer while management works to get the two other divisions on track.

Our analysis indicates that at current dissolving pulp prices, the company should earn over $100 million next year, valuing the company currently at less than 5x earnings. At a minimum, our estimate of the fair value for this unique set of assets is almost double the current share price, and it should be substantially higher provided that dissolving pulp prices remain robust and management is able to successfully ramp its recently acquired second dissolving pulp mill.

On the big cap front, we sold our Aetna, Microsoft, American Eagle and Apple as they ran up close to our FMV estimates, allowing us to seek other investments with better potential. We sold Apple after it gave a sell signal. It had run up over 45% in a brief period and was inflecting down from a ceiling at 5.7x adjusted book value in our TRAC™ work where it had inflected down from a few times in the last 3 years. We will watch closely to repurchase again at the lower break point.

So we added Best Buy and Office Max, then selling a portion of Office Max after it quickly rose and inflected from a ceiling in our TRAC™ work (a “sell” signal), subsequently repurchasing what we sold when it set back to the floor.

Best Buy has become a value opportunity from lacklustre sales, restructuring efforts and the perception that its business is in decline losing out to Internet vendors like Amazon. This overlooks the fact that the company has a growing 50% brick and mortar market share and, while on-line competition is real, BestBuy.com is a formidable on-line competitor. Best Buy’s annual free cash flow remains above $1.5 billion. Its enterprise value is about $8 billion. So, as long as free cash flow remains steady, its cash on hand should equal its current share price in 5 years. At less than 5x free cash flow it currently has over a 20% earnings yield. The company has a sustainable mid-teen return on capital, a well planned cost cutting program and various growth initiatives including aggressive growth in China. And, its mid-cycle margins were 50% higher than currently forecast. Our fair value estimate is over $44 per share, twice the current share price.

OfficeMax is a large organization masquerading as a small cap company. It has $7 billion of sales, 19,000 employees and operations in 4 countries including about 1,000 U.S. retail locations, Grand and Toy in Canada and the 9th largest E-commerce site in the U.S. (after companies like Apple, Dell, Amazon and Staples).

The company’s market cap is about $380 million while the company has net cash of $125 million. Including the significant on and off balance sheet items, we see $180 million in non-operating value at OfficeMax. Therefore, we are essentially paying just $200 million for the current free cash stream of $60 million or about 3.3x free cash flow. The executive team has successfully cut operating costs which has provided them with confidence to offer 2012 guidance of about $120 million of EBIT. And, during ‘normal’ employment and business formation years the company has earned 2.5%-3% EBIT margins which translates into nearly $200 million using today’s somewhat depressed revenue run-rate.

We believe the share price is depressed at $4.20 because investors have been discouraged by the deferral of initial 2012 plans due to weak sales attributable to minimal small business formations while delivery costs (read fuel) have escalated. Our appraised value is $10 per share based on 10x free cash flow of $.80 per share plus the $2 per share of non operating assets. We anticipate further growth to $15 over the next 3 years.

As we continue to add larger cap companies, we also just bought MetLife and NII Holdings (formerly Nextel International)**.** ***MetLife*** is a dominant international life insurance franchise which trades at only 7x earnings. Low interest rates have impacted earnings and MetLife recently was blocked by the Fed from increasing its dividend and doing a share buy back because of issues at its small (less than 2% of profits) banking arm. The headlines alone made it seem as if MetLife itself had failed a stress test. Its banking assets are being sold in the second half of the year, thus removing the issues. Our appraisal value is over 40% higher than the share price, and it is growing. We are looking for a potential return in excess of 25% per year over the next 2 years to fair value.

NII Holdings was added after its share price fell as a result of lower than expected earnings, higher than expected capital spending plans from its transformation to 3G networks and increased competitive threats. The company sells mobile products under the Nextel brand in Brazil, Mexico, Argentina, Peru and Chile. Although it has a clear and ambitious plan to grow subscribers by over 50% over the next 4 years and remains highly profitable, the market is pricing the company at less than 50% of our appraised value, below 6x 2013 free cash flow and at 65% of its liquidation value—the value of its spectrum and towers alone. If we assume a more appropriate 12x multiple and over $800 million of expected free cash flow, we would expect the share price to potentially triple in 3 years.

Income Accounts

Though less liquid than investment grade corporate or government bonds, our income holdings are either higher-yielding corporates where we believe the risk/return is favourable, often with potential for capital appreciation, or REITs and high dividend-paying common shares, equity positions which currently represent less than 20% of income portfolios.

In contrast to government bonds (about 2% yields) and investment grade corporates (2-4% yields), our holdings have an average current yield (income we receive as a percent of current prices) of around 9%. The yield-to-maturity could be even higher from anticipated capital gains as discounted positions increase to their maturity value, and from the conversion privilege (based on the equity value) of some of our convertible securities as their underlying stock prices increase. And, also benefit from a potential upwards revaluation in the undervalued REITS and common shares we hold. As some of these holdings are equities (or debt convertible into equity), our estimates are subject to the inherent risks of equity holdings and the vagaries of the markets.

We review a multiplicity of issuers in an attempt to find opportunities where interest coverage and asset coverage are well above average (to mitigate potential risk of permanent loss) and the return relatively high (both from current income and the potential for capital gain).

Our top holdings include:

Specialty Foods, as mentioned above, continues to deliver. The debentures remain well covered by assets and earnings, and holders could also benefit from a gain on the share purchase warrants through an increase in the equity value; *Advantex's* profits have been growing along with its merchant base—both of the debt issues we own are secured by the company's receivables, one with potential conversion value; *Southern Pacific Resources'* assets well cover its debt including our convertible debenture with its share price only 25% below a conversion price that is well below net asset value; *Student Transportation* operates a steady school busing business the value of which we believe is 25% above the share price and growing; *Pivot Acquisition* convertible debentures have substantial asset and interest coverage and as mentioned above have considerable potential upside from their conversion privilege; *Smith & Wesson* bonds having moved higher still have a solid yield and the company should have as much cash as debt by year end; *Dynacor* debentures are secured with high asset and earnings coverage and we stand to receive a bonus amount too if the company exceeds an EBITDA threshold; *Seitel* bonds have an above-market yield with substantial asset coverage; *Brookfield Real Estate Services* is an undervalued stable royalty business; *Radio Shack's* shorter term bonds (Aug. 2013) are covered nearly 2:1 by its cash while its longer term bonds (May 2019) are well-covered by the company's free cash flow.

In the quarter we sold Lender Processing Services bonds after they ran up shrinking the yield. Other than Radio Shack bonds acquired this quarter, we also bought: *Pinetree Capital* debentures, maturing May 31, 2016, which yield over 12% and are well-covered by the assets of this closed end fund; and *Gran Colombia Gold* bonds, maturing August 11, 2018, which have a yield to maturity of 8% but a much higher potential return through a participation provision if silver remains above $15.

What's New

We have spent endless hours trying to perfect our TRAC™ work, adding TRIM™ and TEC™, our econometric model, in order to mitigate against another '08 type debacle. The nature of our TRAC™ and TRIM ™ work is described in some detail on our website. We've run countless backtests on our TVM (Trapeze Valuation Model) work to constantly enhance our valuation techniques. We have a philosophy of continuous improvement and believe our team and methodology are the best they've ever been.

But it's the cheap stocks that underlie the confidence in our performance. We are highly optimistic because we believe our holdings are trading at such low levels relative to our appraisals. Just how cheap are some of our holdings? Well, at year end, if Manitok decided not to grow but merely drilled 3 wells a year to subsist, it would still have excess free cash flow of around $35 million each year. With an equity market cap of only about $90 million, that would represent a 40% yield. St Andrew, at prevailing gold prices, should have cash virtually equal to its share price in 3 years, even after all of its growth expenditures. We'd be getting the entire business free—a business that's now earning about $50 million pre-tax annually. Orca's earnings yield is about 15% today and earnings are set to really ramp as capacity expands. Dell could have net cash equal to its share price in just over 4 years and an earnings yield now in excess of 20%. It's highly unusual to find such values and highly improbable for these depressed prices to persist. In the absence of unforeseen events the prices are likely to ascend to be more in line with the values. Bottom line, we believe, over time, that the stock prices should rise as value accumulates on our companies' balance sheets in the form of cash or net assets.

Even as we wait the companies are not sitting still, but growing smartly. Generating cash which is being redeployed to expand their underlying values. Nor are we sitting idle, but are continually assessing the 2-3 year outlook of our holdings. Revising appraisals. Making changes if a situation worsens or a better opportunity presents itself.

We are often asked, why can we see something others don't. If it's so cheap why don't others see it? But that's what value investing is all about. There may be an explanation for why a security is mispriced, often some misguided view, but value is in the eye of the beholder. We do our research, apply our testing and calculate our valuation appraisals. As noted above, we will have winners and losers, but believe the probabilities are in our favour.

And we're working hard to increase value for our clients for whose loyalty we are grateful. Through the experience and skill of our dedicated employees and the methodologies we've developed, we look forward to providing meaningful performance ahead.

Herbert Abramson and
Randall Abramson, CFA
May 7, 2012