TRAPEZE
ASSET MANAGEMENT

BIFURCATION BLUES

Bifurcation. A very technical sounding word. It merely means "a division into two parts", which is what we are witnessing in many areas related to investment, both macro and micro. And it is exhibiting to value investors those areas to avoid and the most attractive to embrace. And giving rise to a wide range of disparate opinions among economic and investment professionals as to what outcomes are likely. Needless to say, we have our own strong views.

Macro Bifurcation

As to the macro picture, there is lots of bifurcation. A mixed bag. The U.S. economy is generally improving even though GDP in Q1 at 2.5% was less than an expected 3%, from lower exports to the depressed European Union and lower defence spending, offset by the biggest increase in consumer spending in two years. U.S. factory output fell in April, suggesting growth may be slowing.

But there are many other positives that suggest the U.S. economy overall is improving. Housing is improving as home prices recover and housing affordability remains high. Job creation is accelerating with jobless claims at pre-recession levels. The major U.S. stock indices have been making record highs with more investors participating, creating a wealth effect from better stock and house prices to contribute to consumer spending. April retail sales were a little higher. And consumer sentiment in early May was the highest in almost six years. As a result, tax receipts have been higher, reducing increases in the fiscal deficit and delaying hitting the debt ceiling. And, of course, the Fed is still pedal to the metal with quantitative easing, to keep interest rates near record lows, and continuing its $85 billion per month purchases of treasuries and mortgage backed securities, continuing to help the economy. And the U.S. dollar has responded, the strongest against the yen since October '08, the highest in a month against the Euro, and after almost a year, on par with the Australian dollar. Its strength seems to be based on the belief the Fed later this year may start to withdraw stimulus. And its strength is pressuring gold, oil and other commodities priced in dollars and making them more expensive for foreign buyers.

However, the 17 nation Eurozone economy continues in recession, with a record 12.1% unemployment (an all-time high), and the worst hit countries in depression, Spain and Greece for example. Unemployment in Spain is 26.7% and in Italy is 11.5%. France just slid into recession too, but Germany, on the other hand, the largest Euro economy, is still growing slowly, its factory orders and exports increasing and its jobless rate at a two decade low. Bifurcation. So unemployed workers are migrating from the depressed Eurozone countries to Germany. Good. And the European Central Bank just cut its benchmark interest rate by a quarter point to a record low of 0.5%. Good.

The U.K. seems to be doing a little better dodging recession by growing 0.3% in Q1 and getting some migrants too, likely more of the wealthy kind.

Asia is bifurcated too. The world's second biggest economy, China, had lower GDP growth of 7.7% in Q1 down from 7.9% the prior quarter and from 14.2% in '07. China reported the fourteenth straight monthly decline in factory output and prices (from overcapacity in many Chinese industries), lower industrial production and slowing retail sales. And it had only slight increases in industrial production and retail sales in April.

Meanwhile the third biggest economy, Japan, is targeting higher inflation, spending and growth with abandon. Abenomics, as it is affectionately known, is seeing Japan buying bonds at twice the rate of the U.S. Fed relative to GDP, seeing its yen decline by a fifth, making Japanese exporters more competitive, seeing its stock market soar 64% since November and real estate prices rise, boosting household wealth and tourism too. Japan's economy grew last quarter the fastest in a year. You've got to love Abe's bifurcation.

Our own Canada is slowing, becoming bifurcated from its major trading partner to the south due to a somewhat slower U.S. economy, the softening of commodity prices, a high currency, weak private sector employment numbers and an overpriced real estate sector predicted by many to correct.

Stock Bifurcation

Moving down the scale somewhat from the macro, as we discussed in our last letter, interest rates continue to be administered low, the ECB as we note just cutting rates, Australia and South Korea too, and Fed quantitative easing intentions confirmed. The dividend for the S&P 500 is 2.05% compared to 2.00% yield on the 10-year treasury. Bifurcated for sure—inasmuch as normally bond yields are higher than dividends. So, what is a risk averse investor, getting paltry interest income returns, to do? Well, as we've just seen, he migrates to equities, not just of any kind, but initially to the biggest and safest kind—the so-called defensive stocks, safe dependables—the closest to a bond proxy—dividend paying consumer non-discretionaries, utilities, telecoms and nondurables making and supplying necessaries, toilet paper, toothpaste, Band-aids, food and the like. Kimberly-Clark, Colgate, Johnson & Johnson, Clorox, Walgreen.

And, until recently, that cadre of stocks—at 18 times their slower growing, admittedly dependable, earnings—has outperformed, driving the S&P 500 to a record high, even while the economically sensitive names—the cyclicals, energy, materials, technology, industrials and consumer discretionary—at much lower earnings multiples than the safe dependables, have been lagging.

The S&P 500 is back to about 14.6x earnings while the Value Line (1700 U.S. stocks equally weighted) is closer to 18x. That's an earnings yield of 6.8% and 5.5% respectively; not bubble levels, particularly relative to today's low interest rates (2.0% 10-year U.S. treasury yield) but at or above fair value. Therefore, we generally expect U.S. stocks to merely return the dividend yield (2%) and some modest growth, with no upside revaluation potential. Though carefully selected individual stocks can still provide potentially high rewards. They may not be easy to find now, but by screening our 1000 company large-cap universe we are managing to uncover investment opportunities in healthy, large-cap businesses trading at floors in our TRAC™ work, at discounts to their fair market values (FMVs), often with appreciable growth and perhaps even a decent dividend yield. At the same time we wish to avoid the

Kimberly-Clarks or the Colgates which have ascended to being more than 20% overvalued. While we have seen other divergences like this continue for several months, they almost never carry on beyond that.

Bifurcation Bogey

Well, we believe the defensive names have become overvalued and the economically sensitive names are undervalued and therefore the place to focus. Cyclicals are trading at the largest discount (over 30%) to defensives since 1990. As investor confidence continues to improve and more investors return to stocks, even with the Dow at recent record highs, stock ownership in the U.S. remains at the lowest level since 1998. But as investors do return and with the stock market at new highs, we believe the better valued economically sensitive names will outperform. And that's where we have been focused. Our bifurcation bogey. We are value investors and the bifurcation we've seen is creating a significant opportunity for patient value investors.

U.S. Large Caps Extremely Bifurcated From Canadian Small Caps

Needless to say Canadian small caps, suffering from their illiquidity and volatility have really underperformed and remain incredibly cheap. The ultimate bifurcation. Opportunity for contrarian value investors who look to take advantage of the bifurcation.

As value investors we buy what's undervalued (unpopular) and often short what's overvalued (popular). With the commodity correction of the last few months, our holdings in the unpopular energy and gold stocks are washed out and significantly undervalued.

While U.S. small caps have now generally been embraced, with the Russell 2000 near all-time highs, anything resource based has been shunned. The share prices of large-cap resource-based bellwethers like Teck Corp. and Barrick Gold, and most others, have floundered to multi-year lows. So it's no wonder Canadian small caps have suffered unduly—but the magnitude of the suffering is astonishing. The TSX Venture Exchange is now down 72% from the '07 highs. We cannot imagine this excessive bifurcation lasting much longer. Commodity prices and investor sentiment should strengthen with the recovering economy and the wide value discrepancy—both on an absolute basis and relative to other market sectors—should bring funds back into the ultra-cheap Canadian small caps.

Our small caps have earnings yields of over 20-30% versus the Value Line at less than 6%. This bifurcation should not last.

Inflation Or Deflation

The other important theme, where there is clearly bifurcated opinion, is inflation versus deflation in the developed countries. Recently there have not been any apparent inflation risks, rather, more deflation concerns. April U.S. import prices and export prices both declined. Consumer prices fell in April, from slack in the economy. Canadian inflation has also recently fallen from the slowing economy. But while central bankers don't want too much inflation, with which they believe they can deal, they clearly prefer it to deflation which is a far tougher condition to correct. Bernanke just cautioned that premature tightening could slow the recovery and cause inflation to fall further. Even though the recent collapse of the gold price and the prices of some other materials might suggest a deflationary outcome, we believe the opposite case is likely. The printing of money by central banks is pervasive, and interest rates are being kept below the inflation rate, encouraging borrowing and spending.

Interestingly, at current low interest rates and better stock prices, margin buying by more confident U.S. investors has increased, 28% higher than last year. More risk tolerance for more potential return. Apple, with the world's biggest market cap and cash on hand of $140 billion, clearly thinks buying on margin is good too, and is issuing bonds for the first time in 17 years—the biggest bond issue in history—for buying back shares, or increasing dividends. Neither a lender nor borrower be, but if one has to choose, at historically low rates, be a borrower.

As renowned economist Milton Friedman declared, "Inflation is always and everywhere a monetary phenomenon." Some countries, such as Japan are actually targeting more inflation, with more money printing and a lower currency. Indeed, all countries want a lower currency to help exports and investment. For sure the Europeans want a lower Euro and are frustrated by its strength. The Canadians need a lower Loonie. The Australians are currently achieving a lower dollar. The Chinese could ease monetary policy if growth slows further. And the Fed must certainly be agitated with the recently higher dollar even as its GDP weakens.

Austerity is out. Spain renounces it and European policy makers concede. Reducing fiscal deficits is deferred, especially with concerns of deflation and slow economic growth. Stimulus through increased monetary aid is in. Forget the fiscal deficits, focus on reviving economic growth, employment and reflation. Money printing, stimulation and lower currencies are reflationary, and spell inevitable inflation to us.

Bonds vs. Equities

Bond investors will ultimately get hurt. Warren Buffett recently said he feels sorry for investors who have clung to fixed-dollar investments. Clearly, he thinks they are no safe haven.

Initially, rising inflation will be bad for bonds and good for equities. Excessive inflation will be bad for both. But good for borrowers, such as highly indebted governments, and bad for savers who are destined to be repaid in deflated currencies.

Bill Gross, manager of the world's largest bond fund, warns the Fed bond purchases may fuel inflation and that the 30-year bull market in bonds is dead. Economist David Rosenberg who was for many years an advocate of bonds, is now bifurcating to the inflation camp, actually to stagflation, believing the U.S. 10-year treasury will be 3% in a year (up from a current 2.0%) and over 4% by 2017. He is forecasting an era of slow growth and cost-push inflation with rising labour costs from lower unemployment and lower productivity.

Rising inflation will cause a movement from fixed income to equities and real assets. After two decades of economic stagnation, Japan has finally figured it out. So will currently fearful investors, and embrace cheap stocks, not just the safe dependable more expensive ones, seeking to exchange a risky low fixed income yield for a better and rising stock earnings yield some of which may come as dividends. Safety, like value, is in the eye of the beholder.

Market Correction From Bifurcation

We believe the U.S. bull market remains vulnerable to a short-term correction as it continues to rise with a narrower bifurcated focus. A sector rotation is overdue and we expect the TSX to outperform the S&P 500 and more cyclical industries to behave better than the safe dependables—consumer staples and utilities—which have run up to unsustainable levels well above their FMVs.

With no TEC™ (economic) alert and no TRIM™ (market panic) signal, we do not expect a bear market anytime soon. However, the Dow and S&P 500 are at ceilings in our TRAC™ work and are now above fair value and due for a bull market correction. While the NASDAQ and S&P/TSX appear less vulnerable, in an attempt to protect we have raised some cash, maintained some short exposure (where authorized) by selling short overvalued individual stocks, and bought index puts (where authorized). Unfortunately the shorts, while only about 11% of the portfolios, have mostly run higher and the puts, though less than 1.5% of most portfolios, expired worthless (the cost of hedging) because the U.S. markets have kept rising in the last few months. We just added S&P puts (where authorized) at a cost of about 0.6% of portfolio values (based on 100% growth accounts) to hedge approximately one-half of our equity positions below 1630 on the S&P 500 between now and mid July.

Bifurcated From Their Business Performance

While we are pleased that the performance for our accounts over the last year has been positive, we are still clearly not satisfied with the results. Our accounts have been held back by the backdrop. The headwind of falling commodity prices, and the 33% decline since last May in small-cap Canada (the TSX Venture Exchange Index), are tough trends to buck.

What does satisfy us, though, is the underlying performance of the businesses and progressing values of most of our holdings. As we often remark, if these were private companies with their report cards merely being their financial statements we would be rather pleased. However, each is a public company whose prices, in the short term, are dictated by public sentiment. And for the last number of years the public has exhibited its disdain. We can look to two things to counter this trend. First, the discrepancies between values and prices are wider than they typically get and, secondly, the underlying values continue to grow.

Our large-cap holdings have done well. We have bought and sold a number of them over the last couple of years—some, like Aetna and Och-Ziff, more than once as they fell to a floor and then lifted back up close to our FMV estimate on more than one occasion. It's the small-cap names that have caused us grief. Clients ask why we simply don't sell them and merely concentrate on large caps, even as our declared preference is that "bigger is better." The answer currently is, we are extremely reluctant to replace our current 30-50 cent dollar small caps (i.e., those trading at estimated 50-70% discounts) with large caps at 80 cents on the dollar (estimated 20% discounts). We don't even need to see our small caps recover right to fair value. If choosing between a small and large-cap stock, both 70 cent dollars, we generally prefer the large cap for their superior liquidity and, generally, lower volatility. But our small-cap positions are so far below our fair value estimates that we believe it is prudent not to part with them yet.

For those clients with growth objectives but who prefer not to endure the volatility of small caps, we have lowered their portfolio weighting of, or even eliminated, the more volatile small caps (notwithstanding their potential from this bifurcation) in favour of large caps, and we can certainly tailor any individual portfolio in that regard. In any event, we are continuing to grow our large-cap exposure for all growth accounts whenever the market allows, in a market correction or from company specific issues.

Patience Required To Realize Value

When stock prices suffer, despite the discount to FMV and growth of their underlying businesses, it's easy to lose patience. Ben Graham, the father of investment analysis, noted this phenomenon decades ago with this, our favourite, saying, "In the short run, the market is a voting machine, but in the long run, it is a weighing machine." That is, in the short run, market sentiment dictates the price of a stock, while in the long run, the value of the business and the stock price should coincide. We can take solace in the fact that we are not wasting time. For example, even if the share price of Manitok, our largest holding, isn't rising right now, its business is. The company drills one well per month and, with each well having over a 90% chance of success and a 70% chance of adding at least 265 bpd of production, value continues to be added. Today it produces about 4,500 bpd which is expected to grow to more than 5,200 bpd by year end. At a mere $65,000 per flowing barrel—transactions to buy production having taken place at much higher prices recently—we believe that over $4 per share of value is warranted today, over $5 by year end, and over $6 by the end of 2014, versus its $2.56 share price today. While today's 40% discount may not be terribly extreme, the 60% discount to the end of next year's value is too wide. We do not believe that such a discount can prevail. So we continue to embrace companies trading at wide discounts to our FMVs whose values we expect to rise even further in the near future and await the results of the weighing machine.

Our Key Holdings Instill Confidence

Manitok Energy's drilling success has been remarkable—13 for 13 successful wells with production results above the expected type curve. The share price is now supported by its reserve value (about $2.35 per share at the end of last year). More importantly, the production and cash flow growth justify a much higher value, with production closing in on 5,000 boe/d and an annualized cash flow run-rate over $60 million.

The company's hypothetical free-cash flow yield (if it decided to stop growing and merely drill sustaining wells each year) is about 23%. Though, the company won't free-cash flow because with over 80% internal rates of return on wells drilled it will, understandably, use all of its cash flow for further drilling. Manitok is expected to continue drilling at least one well per month for the next few years, which, in our view, should materially grow underlying value. We see few material risks for Manitok, other than the price of oil which we believe should remain at or above current levels for some time. The reservoir appears superb with most wells free-flowing oil to surface (i.e., without fracking) and a couple of the wells amongst the best drilled in the Alberta foothills in the last 25 years. Assuming $85 oil, in just 3 years' time, Manitok should have annual cash flow of more than $1.80 per share, and at a valuation of 5x cash flow, it would justify a share price more than 3x today's level.

St Andrew Goldfields delivered a near-record quarter of production with 24,461 ounces in Q1 '13 and is on track to produce more than 100,000 ounces for the full year. Cash flow continued to be strong too. The shares trade for about 3x cash flow, the balance sheet has over 15% of its market cap in cash (net of debt), and the stock price is less than half its net asset value, even using today's depressed gold price. Gold prices appear unsustainably low, as do oil prices, with both now below their marginal costs of production (the cost to initiate the highest cost projects). While commodity prices can remain below their marginal cost of production (over $1600 per oz. for gold and $105 per barrel for oil) for months while they react to short-term issues, typically they rarely stay there for any lengthy period (usually not more than a year and typically only during periods of severe economic decline). While we could see lower prices ahead for gold and oil if negative sentiment worsens—hard to believe given how especially oversold gold currently is—we anticipate a recovery back above the marginal cost of production over the next 12 months. Moreover, the marginal costs of production have been rising. Gold's was around $300 just 10 years ago while oil's was below $30. Who says there's been no inflation?

The main risk for St Andrew is a sustained period of lower gold prices. We find it unlikely that gold prices will remain low for any lengthy period. Though, St Andrew would only have modest losses even if the gold price temporarily dips below the industry's average all-in cost of production of $1100—clearly an unsustainable level.

Based on normalized free-cash flow of $.09 per share (assuming the gold price reverts back to the marginal cost of production), St Andrew has an earnings yield of over 20%—or about 11% at today's depressed gold price. Our 3-year target for St Andrew remains at over 3 times the current share price (assuming 6x cash flow multiple and gold prices that we believe to be reasonable).

Another gold holding, *Dynacor,* does milling of gold for other miners in Peru, and its stable milling business does not really fluctuate much with the price of gold. The company reported record earnings for 2012 and reported an all-time high production of 20,027 oz. for Q1 '13. The shares trade for just over 4x trailing earnings, a 23% earnings yield. The company is expected to be running a second larger mill by mid 2014 which should expand earnings power to about $0.35 per share annually. If the company traded at just 10x earnings, this could more than double the share price based on its then milling alone, excluding any value attributable to its own exploration properties. But, in the meantime, the first results from Dynacor's own gold mining operations have begun to trickle in which have been good and we hope should excite the market. Many of Dynacor's neighbouring properties have been sold in the past for significant value.

Orca Exploration's share price has fallen to $2.10 despite the company announcing an increase in its reserve value to over $11. We have consistently argued that the company has more than $8 of FMV (our estimate based on both the reserve value and the value justified by its expected cash flows).

The reason for such a wide difference between its price and value is the mess in Tanzania. TANESCO, the national power utility, owes Orca and other suppliers significant arrears and we believe has just started to make some payments from the government's receipt of $700 million of funding. The balance owed by TANESCO should soon be forthcoming. Tanzania struggles with power outages and Orca's gas remains in high demand, the company's gas production generating over 50% of power in the country. A Chinese sponsored group is expected to build a major pipeline which should allow a ramp-up of Orca's production and cash flow once completed. Other major energy companies have also made large offshore gas discoveries nearby, which has emboldened Tanzania's plans to seek better opportunities for gas-fired power.

Meanwhile Orca has long-life natural gas reserves, operates at low costs with high netbacks and we continue to believe that the company's infrastructure, contracts and foothold in the region could have appeal to some of the majors operating there allowing Orca to monetize assets in the next couple of years.

Our valuation for Orca is over 3 times its share price. The company just reported another quarter of record earnings and cash flow but its results have been completely overshadowed by the government uncertainties. Orca's balance sheet remains clean, with sufficient cash which will expand as the national utility pays all the arrears, which should also allow the company to pursue its plans to drill the highly prospective Songo Songo West gas field, after it finalizes a new satisfactory Production Sharing Agreement with the government.

Specialty Foods Group repaid all of its debentures at the end of '12 leaving us with only the warrants which are exercisable into equity. The warrants are likely worth much more than our current carrying value which was based on a third party valuation. This private company is expected to keep its costs low (it has limited need for capital spending) and generate substantial free-cash flow until the expiry of the manufacturing/distribution contract with Nathan's early next year. Then it will likely liquidate its assets and return capital to its stakeholders.

AIG has performed well though the stock still trades for only two-thirds of book value. Now that the government's stake is gone, the company is more likely to begin returning excess capital to shareholders later in the year, especially after the company sheds further non-core assets. Book value per share could rise to around $70 in a year, and if the price traded up to only 85% of book value over the next 2 years, we could have a return in excess of 20% per year.

MetLife, along with other insurers, has been the beneficiary of higher interest rates. It trades at just under 8x earnings and, like AIG, well below book value. Also, like AIG, the company has excess capital which it will likely return to shareholders—the company recently hiking the dividend by 49% to a 2.5% yield. If the share price recovers to only 90% of its book value, including the growth we expect, our return would be about 20% per year over the next 2 years.

Pivot Acquisition did a small raise a few weeks ago concurrent with a reverse takeover of a small TSX company and now trades publicly. Our 12% convertible debentures (held in our taxable accounts) were rolled into preferred shares with similar terms. The preferred shares carry a premium yield until later in the year when they convert one-for-one into common shares. Because the company was private and illiquid for some time, there has been selling pressure after the company listed its common shares at $.80. Due to its brief trading history, small public float, and lack of following, even the modest selling has temporarily overwhelmed buying demand, driving the common price down to $.27, the shares now trading for only about 3x cash earnings. At a more appropriate multiple of 9x, the value is over $.80 per share and much higher over the next couple of years as the company continues to grow both organically and via acquisitions.

We recently added to our *Corridor Resources'* position where clients were underweighted. We believe the worst is behind the company. Natural gas prices have recovered substantially and Corridor believes pricing for its gas into the undersupplied New England market should continue to experience a premium of $2.50 or more per mcf for years to come. We expect the Repsol LNG import facility in New Brunswick to add a smaller modular plant to generate LNG for export, which will require local gas supply from producers, likely to include Corridor's Frederick Brook shale field, which in 2011 showed promising results and with over nearly 1,000 metres of depth is amongst the thickest gas shales in North America. Corridor is seeking a partner to develop it.

We also anticipate a partner for the company's Anticosti Island, Quebec shale oil project soon. The PQ government appears favourable towards shale oil and the development of Anticosti Island where Corridor alone has 19.8 billion barrels of oil equivalent resource in place.

And the Old Harry project in the Gulf of St. Lawrence, which has a potential 2 billion barrels of recoverable oil, where Corridor is also seeking a partner, is more likely to occur after the completion later this year of the ongoing Federal environmental assessment.

The company guided to $8 million of cash flow for this year. The current share price implies 7x cash flow which means we are essentially getting all of the aforementioned mega-projects as a bonus. Any one of these projects alone could provide material upside for Corridor. While Corridor still needs partners to advance these projects, the company generates cash flow and has nearly $15 million in working capital while it awaits potential partnership arrangements for its three projects.

We continue to believe the risk-reward ratio is unusually attractive.

New Large-Cap Additions

Jabil Circuit manufactures electronic components and provides services such as design engineering and supply chain logistics management. We purchased Jabil shares after the company missed earnings estimates because of too quick of a ramp-up for casing manufacturing for the iPhone 5 launch. Early yields were poor, pressuring margins. Almost 20% of its revenue is from supplying Apple. We do not see Jabil's reliance on Apple as a risk though, inasmuch as that relationship has grown steadily with Apple investing hundreds of millions with Jabil for capital expenditures. Jabil is taking steps to diversify its business with its recent acquisition of Nypro, a leading manufacturer of precision plastic products. We see Jabil earning approximately $2.70 for 2014. Earnings could get a boost if Apple introduces a new lower-cost iPhone. At 8x earnings, Jabil trades at about 70% of our FMV. With 7% growth and a 1.5% dividend yield, Jabil has the potential to recover to its FMV, around 11x earnings, and provide a more than 25% annualized return over the next 2 years.

ThyssenKrupp has stumbled over the past two years with a troubled €12 billion steel mill expansion in Alabama and Brazil and price fixing allegations at its rail steel unit. ThyssenKrupp's shares trade for just €15.16, down from €36 where it traded in the summer of 2011. But underneath the wreckage we see a company in the midst of a positive radical transformation. The company is very close to selling its U.S. and Brazilian steel mills. An allowance of €200 million has been made for fines and penalties related to its rail steel division. By the end of the year, the two main problems that have plagued the company should be behind them. The new ThyssenKrupp will look much more like a traditional diversified conglomerate with steel production accounting for just 30% of revenues. The bulk of the business will be concentrated in elevator technology, high-tech components, and specialized engineering technology—all businesses that have higher and less volatile margins than steel. With a focus on steady earnings and margins, we believe ThyssenKrupp's earnings multiple will be re-rated higher. A sum-of-the parts analysis and a 12x earnings multiple both suggest an FMV of €20. Again, with a little growth, we see a potential 25% return per year over the next 2 years.

Arrow Electronics is one of the world's largest distributors of electronics/computer components, serving as a supply channel partner for more than 900 suppliers and 125,000 OEMs. Arrow's growth has declined recently given that approximately 30% of its sales come from the Eurozone, and demand for electronic components from North America and Asia has also softened. However, we see signs that Arrow's business is slowly rebounding. Management recently noted that March's book-to-bill was positive and the outlook for North American sales was more constructive. Management isn't simply waiting for the environment to improve, launching an aggressive cost cutting program. If the Eurozone returns to growth and management's cost cutting program is fully executed, we believe Arrow could generate $5 of earnings per share by fiscal year 2014. We see minimal downside given the shares trade at book value and 9x depressed earnings. With our FMV in the mid $50s, or 13x earnings, Arrow too meets our 25% annualized 2-year potential return hurdle rate.

EMC provides enterprise storage systems and server virtualization software through its VMware subsidiary. Investors have been concerned about the lackluster IT spending environment and the commoditization of storage solutions. However, EMC continues to grow organically and gain market share. The shares trade at just 11x (excluding cash on hand) estimated forward 12-month earnings. We believe the current price is unjustified as new products such as ViPR and Pivotal and a refresh of its VNX unified storage series should result in a high single-digit EPS growth rate over the next few years. Our FMV estimate is about 25% more than the share price. With the growth we assume and the undervaluation alleviated over the next couple of years, we look for a potential annualized rise in excess of 25%.

We also added to our *NII Holdings* position on the recent pullback in share price. The company continues to meaningfully repair its balance sheet, and, with the expected tower sales by the end of the quarter that process continues. We see tremendous asset value which should translate to earnings-based value over the next 18 months.

We bought and sold a little *Apple* too recently, trading around our core position. We averaged down when the stock fell to a floor in our TRAC™ work but then sold some when the price recovered after its earnings release.

We also bought and sold Staples after it quickly ran up to a ceiling and closer to our FMV on the heels of the Office Max/Office Depot proposed merger announcement. We sold our Best Buy position as well after it climbed back up to $22. We believe the company has turned the corner and we would look to reinitiate a position if the price were to weaken again. Aetna and Och-Ziff were both sold too as they reached ceilings in our TRAC™ work and lacked further immediate potential upside based on our view of their respective FMVs.

We sold about one-third of our *Southern Pacific* shares recently, only because the share price gave us a TRAC™ sell signal and we believed the market would continue to be concerned with the delayed ramp-up of production. The company is still in the early stage of commencing production, steam is being injected into the formation and 7 of the 12 well pairs are currently producing oil. Volumes are building but very slowly. Management is conservatively ramping the project. Meanwhile, temperatures are rising, pressures are building and increased production should follow in the next few months. We still expect McKay to reach its design capacity of 12,000 bbl/d within the next 12 months. As volume builds and the project delivers, the significant discount to our FMV is expected to narrow. Though the market appears focused on the risks associated with the losses (about $3 million per month) and the debt load, the share price seems to have totally overreacted to the production delays especially since proven reserves are over $1 billion or $1.40 net per share—nearly 3 times the share price.

For our larger cap mandates (and RSP accounts) we sold Berkshire Hathaway after it ran up to a ceiling which was close to our FMV. United Health Group was sold for the same reason. And we more recently added positions in *Netgear*, a leading consumer and enterprise networking company and *C.H. Robinson*, a leading transportation and logistics company, each of which trades below our estimate of FMV.

Like most of our other large-cap holdings we are looking for a potential return from each of these large caps in excess of 25% per year over the next 2 years as they recover to our determination of FMV. We continue to analyze many large companies, constantly reviewing the most undervalued stocks in our universe of about 1,000 global large-cap stocks.

Income Holdings

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

Our holdings have an average current yield (income we receive as a percent of current market value) of just under 9%. The overall portfolio yields are lower as we are carrying more cash than usual. After selling a few positions recently, we are taking our time to find appropriate replacements, not easy in this low-yielding environment. A number of our existing positions have declined in price, particularly the ones whose underlying businesses are commodity based given the decline in commodity prices and most resource based shares. But we still expect capital gains as these discounted securities rise over time to their maturity value.

We continue to screen for a multiplicity of issuers in an attempt to find income 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).

Of note, regarding our top income holdings: *Advantex's* profits continue to grow as it expands its merchant base; *Smith & Wesson* bonds are well covered by the cash on its balance sheet and the company's consistent profits keep adding to the cash hoard; Specialty Foods Group, as mentioned above, with the bonds fully repaid we merely hold the warrants which continue to provide potential upside; *Pinetree Capital* debentures have held up reasonably well despite falling commodity and related equity prices, and the company has been buying back its debt; *Dynacor* debentures will mature next month as the company keeps generating cash every quarter; *J.C. Penney* bonds have performed better since the firing of its CEO and additional debt financings; *Pitney Bowes* preferreds have risen as well after the substantial common dividend was halved; *Southern Pacific's* convertible debentures, as mentioned above, have been our worst performer though the asset coverage remains substantial with over $1 billion of proven reserves against $430 million in total corporate debt and the McKay project should really start to deliver over the next few months; *Brookfield Real Estate Services* keeps collecting its royalties which are steady because they are based more so on the number of real estate agents rather than Canadian real estate prices or sales levels.

Pivot Acquisition, mentioned above, has seen its common share price fall since recently going public, which has negatively impacted the carrying value for our preferreds, which automatically convert one-for-one into the common later this year. But since the company is quite profitable and growing, we view the depressed price as temporary.

Our Seitel bonds were redeemed by the company at par value. We sold our Ferro bonds and our Radio Shack bonds after they ran up in price in a short period after better corporate results. And after averaging down in our *NII Holdings* bonds, we sold part of the position once the price lifted back up on the heels of an additional financing and the announcement of pending asset sales. We partially replaced those sales with a couple of new positions: *Thompson Creek* 9.75% December 1, 2017 bonds where the senior secured bonds of this molybdenum miner had an attractive 7% yield especially considering the significant asset value securing these bonds—most of the capital spending is behind the company so we anticipate significant free cash flow in 2014 that should help drive down the yield, and lift the price, on these first lien bonds; and *IBI Group* 7.0% Convertible Debentures due December 31, 2014—short-term obligations of professional services firm IBI Group, which offered an outsized yield of 9% without, in our view, outsized capital risk—the yield was high and has gone higher as the architecture and transportation design firm is under what we believe to be temporary pressures from poor organic sales growth compounded by lowered project margins—we expect the relatively small 2014 convertible debenture to retired at par on maturity next year.

Market participants are busy reaching for yield. 10-year treasuries were driven down as low as 1.5% and are now 2%. High-yield corporate bonds went to a record low around 4.5%. And some blue-chip companies have attractive 3 to 4% yields but have seen their share prices rise well above fair value. A bifurcation bubble? We are sticking with our process.

Global Insight Large-Cap Model

Global Insight, our entirely large-cap model, has now been running for about one year. It's up 16.1% (USD) since its June 1, 2012 inception. A complete description of the Global Insight Model is available on our website. And any one of our portfolio managers would be more than pleased to discuss our large-cap process with you.

Updated Websites

Our website has recently been updated to provide a simpler understanding of our firm's overall process and our various managed account strategies. Please feel free to peruse the new content at TrapezeAsset.com.

Our all-cap mutual fund, the Trapeze Value Class, has its own website too, at TrapezeFunds.com, which details how the fund is managed.

Beating Bifurcation

Like other value investors, we suffered from the bifurcation blues in Q1, but believe we are in the right names to ultimately take advantage of the bifurcation. Again, Benjamin Graham, the father of value investing, believed that over the long run the true value of a security would be revealed through its price. He would have liked the current bifurcation, looking to exploit the market's inefficiencies.

Herbert Abramson and
Randall Abramson, CFA
May 24, 2013