TRAPEZE
ASSET MANAGEMENT

HIDE AND SEEK

Hide and seek. A game investors played as children but should not forget these days. Currently, investors need to hide safely to protect from some unfavourable developments in an environment that could hurt them.

First and foremost, the S&P 500 is near a record high and based on our work is fully valued. The U.S. markets did correct recently, but there's likely more to come. Particularly confronted by recent unfavourable economic news and some turbulence.

We believe that market sentiment has been too bullish, which combined with a fully valued market at our TRAC™ ceilings, warrants a correction. We don't believe this is the onset of a bear market, just a healthy correction. The S&P 500 is fully valued based on a multiple of over 16x 2014 expected earnings, on price to sales ratios, on price to book ratios and even based on its dividend yield, leaving little, if any, upside except from earnings growth.

Based on our TEC™ indicator we don't foresee any looming recession; we just anticipate slower than normal growth.

U.S. Economy Uncertain

In the U.S. the economic news has been mixed. On the plus side, U.S. GDP for Q4/13 rose at an improved annualized 3.2%, helped by an ongoing housing recovery and by consumer spending, the biggest driver of the U.S. economy, which rose the most since the last quarter of 2010. U.S. exports also contributed, up 11.4% last quarter, the most in 3 years. U.S. manufacturing in February grew the quickest in almost four years seemingly recovering from the ISM manufacturing index decline in January from December. Furthermore, the U.S. budget deficit should shrink this year to $514 billion, or about 3% of the economy, the lowest since 2007. And this is the stuff that's no doubt encouraging the Fed to continue tapering its stimulative monthly bond and mortgage purchasing by $10 billion per month, now down in the last 2 months to a monthly $65 billion.

But wait, there is lots of negative news too. Recent economic releases have been below expectations. While Q4 GDP growth was better, for all of 2013 the economy grew by only 1.9%, down from 2.8% in 2012. And, while U.S. consumer spending rose in December, lower consumer confidence in January could impede growth in this quarter. Consumer incomes for December were weaker and their savings fell, which could slow their spending this year. Retail sales fell in January to the lowest in 10 months. The housing recovery may be stalled too. Home builder sentiment just recorded a record drop. Housing affordability is declining sharply from higher prices (rising faster than incomes) and higher mortgage rates impacted by the Feds tapered purchases of bond and mortgage-backed securities.

Pending home sales in December had their biggest one-month drop in 4 years. While new house sales rose by 9.6% in January, existing house sales dropped 5.1%. Unusually extreme winter weather hasn't helped either.

January non-farm payrolls were up a disappointing 113,000, though the unemployment rate fell to 6.6% (from 6.7% in December), mainly from people dropping out of the work force. U.S. farm incomes are expected to drop this year to the lowest level since 2010. Auto inventories in January were at the highest level since the recession in August 2009. Generally speaking, this economic recovery has been weak compared to past recoveries from recessions.

And the Fed knows this too, despite its tapering measures voting to keep interest rates near zero, even if unemployment drops below 6.5%. Continuing the needed tailwind.

Global Economy Weakening

Investors also need to be wary of the implications of a general global economic slowdown. Some worrisome stuff, for sure.

The second largest economy, China, is slowing. Its GDP growth rate is down from 12% to 7% and some pundits believe it could be on its way lower, to about 5%. Interest rates have risen materially in China from funding stresses as it tries to shrink the government share of the economy and end its credit bubble. China's Purchasing Managers Index (PMI) for January was down to 51.5 in January from 52.5 in December. Although, positively, its January trade surplus was better from higher exports.

Japan, endeavouring to recover from years of deflation and its recent nuclear power disaster, has unhappily seen the Yen rise lately and its Nikkei index correct by over 10%. Its economy grew more slowly in Q4/13 than anticipated, from weaker consumption and exports, suggesting continued money printing and currency devaluation.

The ECB, concerned with low inflation (the slowest since '09) and a fragile recovery, has kept its benchmark interest rate at a record low of 0.25%. Countries such as Greece, Hungary, Poland and the Czech Republic continue to struggle.

But the emerging markets may be the icing on the cake, or rather, the bricks on the raft. Capital had been flowing into emerging markets, attracted by higher interest rates and formerly stable currencies. Now, despite growth in most of them slowing, Turkey, South Africa and India perversely have all had to hike rates last month to support their currencies and restrain capital from fleeing. Other currencies, including those of Brazil, Mexico, Russia, Poland and Hungary, have fallen heavily as competition for capital has increased. Argentina and Venezuela, in the face of soaring inflation, are becoming basket cases. Puerto Rico too, cut to junk. Emerging countries represent a significant portion of global imports. Adios growth.

Hide In Safe Places

Time to hide from those places that are not necessarily safe and seek safety in those places that are safer. Clearly the U.S., Germany, the U.K., France, China, Japan and Canada, and the developed countries generally, are safer. Growth in the U.K., Germany and France seems to be improving. In Canada too. The Canadian economy gained 29,400 workers in January, the biggest jump since August. The Bank of Canada is forecasting 2.5% growth this year and keeping its key interest rate at its near record low of 1%. However, factory sales, led by aerospace and autos, unexpectedly fell in December. And December retail sales also dropped in December more than anticipated pushing the loonie lower to under US$0.90. But, the declining loonie should help stimulate exports and the earnings of exporters, including aerospace and autos, and the Canadian energy and mining producers we hold, while at the same time restraining any deflationary forces at work and help exports to avoid the recent monthly deficits experienced. Canadian consumer confidence in Q4/13 was the highest since the first quarter of 2011 and consumers should keep spending. Of course, the lower loonie raises the prices of imported consumer goods and hurts some industries, such as the airlines.

Seeking Safe Asset Classes

So now that we know the geographic places to hide from and where to seek, what are the kinds of investments we should hide from and what are those we should seek? Our objectives are to obtain potentially high, market-beating, after-tax returns, without undue risk of loss.

Well clearly, these days, even our favourite countries, the U.S. and Canada, are more risky. While the U.S. Federal deficit has been declining, its debt is still a whopping $17 trillion, equal to GDP. And the debt limit keeps having to be increased by Congress. The Federal Reserve's debt is also $4 trillion. These are big numbers, especially big if interest rates rise. Which, however, currently appears unlikely in the near term. Especially if the U.S. dollar becomes the currency to default to, which could diminish inflation, and perhaps even raise the risk of deflation. Interestingly, even while interest rates are being kept artificially low and money printing artificially high, it has failed to generate money growth in the private banking sector—the so-called velocity of money.

There are also risks in the U.S. markets. With the 10-year Treasury bond yielding 2.7% (down from over 3% from the recent stock market weakness) and no clarity on the inflation outlook, bonds are not without risk and may not be a good place to hide. Remember, this bond bull is being supported by artificially induced assistance from the central bank. We prefer markets that don't need artificial sustenance. Remember the adage, the Fed can always remove the punchbowl from the party. As we have noted, cheap money is generally good for an economy, especially those of places such as the U.S., the Eurozone and Canada, where inflation is not an issue. Not yet anyway. Low rates are good for consumers and for business. And good for the attractiveness of equities, making their returns more attractive relative to fixed income, increasing P/E ratios, and allowing inexpensive margin leverage to enhance returns.

On the other hand, as we have noted, the U.S. markets are in our opinion fully valued, so investors need to be careful. To hide and seek carefully. U.S. profit margins are at record highs (we repeat, “record highs”) and profits are at an all-time high. High profit margins may be sustainable for some time, but normally regress to their mean. The markets have been supported by buy-backs and increased dividends, as opposed to revenue growth which has been anemic. Margin debt is at a record high. And some recent IPOs, like Twitter, have indeed proven to be risky. Shell and Exxon Mobil both suffered from Q4 profit declines. Retailers, such as Best Buy, J.C. Penney and Radio Shack, struggling and shrinking. Huge consumer companies, such as Wal-Mart and Mattel, have had disappointing results, somewhat, understandably, from weather issues. And while Amazon.com benefited from better online shopping, it still had results below expectations, hurting its share price. Which is acceptable if you’re short it, as we are.

Seeking Undervalued Stocks

We want to be defensive, to avoid the stocks that are fully valued and seek those that are undervalued, by at least 20%, and buy them at floors in our work. In accounts that have authorized short selling and options, we seek to hedge risk by short selling the overvalued companies and buying put options to protect from a market decline.

Our analysts work diligently looking for the long and the short opportunities. A great investor once said, “Seek and ye shall find,” and we’re obeying.

Our All Cap Portfolios – Key Holdings

Our All Cap portfolios combine selections from our large cap strategy (Global Insight) with our best small and medium cap ideas. We generally prefer large cap companies for their superior liquidity and, generally, lower volatility. Importantly, they tend to recover back to their fair values much faster. We have increased our large cap weighting and foresee a continuing increase. Our small cap positions are cheaper though as they continue to trade far below our fair value estimates and therefore our All Cap portfolios still hold a concentrated position in small caps.

Manitok Energy is our largest equity holding in most All Cap accounts. The company has driven its value via successful drilling results in its core Stolberg area. Our estimated value is now $4.50, over 50% higher than the current share price. Production should be over 7,000 boe/d later this year which should provide a cash flow run-rate of over $80 million or about $1.15 per share.

The stock price has rebounded in the last few weeks by over 30% from its lows after an undue sell off. The market reacted strangely to the company’s Entice land acquisition and the former COO’s departure while their equity financing clearly removed subsequent demand for shares. The acquisition will be better understood as the company drills wells starting imminently. Entice should quickly prove to be another core area for the company. And Quirk Creek, where further results are expected soon too, should also add an area of growth. A decline in the price of oil, which we do not anticipate, remains the primary risk for the company.

All of this, along with continued drilling at Stolberg, should help push value even higher. Assuming $65,000 per flowing barrel (transactions to buy production have been taking place at much higher prices), Manitok has $4.50 per share of value today and its value should grow to over $6 by the end of this year, compared to its $2.40 share price. Assuming $85 oil (our conservative figure), in just 3 years Manitok should have annual cash flow of more than $1.80 per share, and at a reasonable valuation of 5x cash flow, that would justify a share price more than 3x today's level.

Specialty Foods Group, held in our taxable accounts, is another top holding. At year end, a third-party valuator boosted the value by 34% from the last valuation in mid '13. The company's valuation is now mostly from its cash hoard. The Nathan's hot dog contract is winding down, expiring in March. The company should then be in a position to return capital in a tax-efficient manner to its stakeholders. It will likely sell its remaining brands/operations and then return capital later in the year. We still expect a further lift from our current carrying value as the third-party valuation was conservative.

Corridor Resources' share price has more than tripled from its rock-bottom low of last November. Much stronger natural gas prices have been the driver, rebounding to $5 per mcf as cold weather and lessened drilling have conspired to draw down North American supplies. And Corridor sells to the New England market where the market is extremely undersupplied and receives a premium of about $2.80 per mcf over prevailing prices that should be sustainable for several years. In fact, the company has already locked in part of next year's production at over US$11 per mcf—providing an estimated CA$10 per mcf net back during the 5 key winter months.

Adding to the positive sentiment, the company just announced the first of 3 partnership agreements we have been expecting. The Quebec government and Maurel & Prom will spend up to $100 million drilling on Anticosti Island beginning this summer. Corridor will not have to spend any funds on the project over the next couple of years yet retains about 22% of the partnership and gets $15 million in cash shortly too. That will leave Corridor with about $35 million of cash along with its cash flow, enough to begin growing again at its core McCully field and the ability to spend modestly on the Frederick Brook shales too in order to attract a better potential partnership agreement for that megaproject.

Anticosti Island, Quebec has a projected 33 billion barrels of oil equivalent resource in place. The risked value to Corridor is several dollars per share—multiples of the current share price. Though, even with extremely promising core samples to date, analogous to the prolific Utica shales of Ohio, lots of work is still required to ascertain whether the project is viable.

Frederick Brook, on the other hand, with over 1,000 metres of depth, is amongst the thickest gas shales in North America and simply needs a partner to advance it, now that gas prices have recovered. If the LNG export facilities being discussed in New Brunswick and Nova Scotia go ahead, either of which would require Corridor's gas feed, it'll really be a "game on" event.

And Old Harry, Corridor's Gulf of St. Lawrence offshore area, which has a potential 2 billion barrels of recoverable oil, could also land a partner before long. The Federal environmental assessment is nearly complete and maybe, given its recent actions, the Quebec government will participate there too.

Even at today's higher share price, the value of the McCully field, its infrastructure and net cash alone are worth the share price. Therefore, the significant potential from the 3 megaprojects is still essentially free.

St Andrew Goldfields delivered record production levels in 2013. While production should see a 15-20% decline in '14, it's the higher cost production that is falling off, from depleting mines—where the company wasn't profitable—and increasing production is coming from the lower cost Holt mine (all-in, including sustaining capital expenditures, costs are below $1,000 per oz.). Even better, beyond 2014, the company should be back to producing at record levels again, above the 100,000 oz. per year mark, as Holt continues to grow and the Taylor mine likely begins producing. Gold prices have rebounded too and have triggered a buy signal in our work. Between higher gold prices and a lower Canadian dollar, St Andrew should deliver respectable cash earnings in 2014 and much more attractive figures next year—about $40 million. Meanwhile, the company's financial position is strong with about $19 million of net cash (net of all debt).

The share price still trades at a discount to its blow-down reserve based net asset value. An apparent anomaly considering its next door neighbour, Brigus Gold, was purchased in December at a fair price which justifies a substantially higher price for St Andrew—it's trading at about half of its full net asset value assuming a $1,400 gold price (below the marginal cost of production). Lower gold prices could diminish earnings but gold appears to be headed back up. Our 3-year target for St Andrew remains over twice the share price, assuming a 6x cash flow multiple and somewhat higher gold prices that we reasonably expect.

Orca Exploration's share price has seemed like a stopped watch. The problem is the uncertainty surrounding the company's operations, even though Orca's reserve value of $11 per share reserve is over 4x its share price. We expect the uncertainties to diminish in the coming months. TANESCO, the national power utility, should be in a much better position to repay its substantial obligations to Orca and other suppliers given the price increases the utility received from the government at the outset of this year. The World Bank is involved too and that should help expedite things. And, the new pipeline in the country, to allow expansion, is now more than half built with its commissioning expected in just over a year's time. The risk we see at Orca is the one that's continued to plague the company, a prolonged period before these issues are resolved. However, there's an election in the country late next year and Orca's gas production generates over 50% of the power in Tanzania. The all-too-common brownouts have been at the forefront of the political scene which tells us a resolution should not be far off.

Orca has significant net working capital, record production levels, long-life natural gas reserves, operates at low costs with high netbacks and its gas remains in high demand. Our target for Orca is more than $8 per share or over 3x its share price.

Dynacor's share price has been volatile recently in reaction to the Peruvian government's further crackdown on illegitimate mining practices. Dynacor has been following all the rules and the last time the government became more stringent Dynacor was a recipient of a big lift in its business thereafter, as noncompliant competitors lost share. The company anticipates a similar outcome this time around. But, like last time, the company is forced to temporarily curtail production until it can once again show the authorities all of the paperwork proving its compliance. At about 6x earnings the valuation is still way too low.

Final approval for the company's larger mill is expected soon and construction should be completed about 12 months thereafter allowing earnings power to climb to over $0.35 per share annually. At just 10x earnings, this could more than double the share price based on its milling operations alone. That ignores the value from Dynacor's own exploration properties where results have been favourable—the company should have a 43-101 later this year which we anticipate could show an initial resource in excess of 1 million ounces. As long as results continue positively, the company's own production could begin in about 3 years.

Despite a range-bound share price, *Legacy Oil + Gas* continues to execute its game plan and deliver results. With a large, multi-year development inventory, high netback light oil production with high IRRs and cash flow that is being used to both grow the business and reduce leverage, Legacy has built a solid and sustainable business. Based on the company's 2014 budget, we expect approximately 160 gross wells to be drilled and average production to exceed 21,000 boe/d (13% growth from 2013) and an exit rate of nearly 24,000 boe/d. The next phase of development will likely include waterflood recovery techniques, which could double reserves, lower the company-wide decline rate and improve capital efficiencies going forward. Our estimate of its current value is still over $11 per share and growing by over 15% per year as it exploits its 2,000 net drilling locations. Even at $85 oil, our fair market value (FMV) estimate rises to over $18 in 3 years—nearly 3x today's share price.

Our top holdings in our All Cap portfolios include large cap positions, *Goldcorp, Vivendi* and *Apple*, which are all discussed below in our Global Insight portfolio review.

Portfolio Changes

In the last few months we sold Hewlett-Packard and Qualcomm as both of these large-cap positions ran up to a TRAC™ ceiling, close to our internal valuations. Triumph Group, Samsung, China Unicom and Southern Pacific Resources were also sold as they breached TRAC™ floors in our work. We may look to repurchase them at lower prices.

We recently added retailer *American Eagle* (summarized in our Global Insight portfolio review below).

Trading at 0.2x sales we also bought shares of another teen retailer *Aeropostale.* While Aeropostale has less immediate visibility for earnings recovery, we see little risk of any permanent impairment and the shares offer 100%-200% potential upside over time, assuming the company remains public for some time—at least 3 key shareholders are activists and two were involved in previous retail buyouts themselves. Management has been talking to private equity players too. Meanwhile, it plans to expand on-fashion assortments, add new categories and increase sourcing speeds which should ultimately lead to positive same-store sales and higher operating margins. The timing of these initiatives adding to free cash flow is our largest unknown.

Denim focused retailer *Guess?* was added too. At 15x current free cash flow, with the company under-earning by 700 basis points of margin, we see significant operating upside driven by an improving Western European economy and higher domestic sales per store. We estimate fair value at $38 (or 12x normalized free cash flow) about 30% higher than the current share price.

Near term weakness caused by higher cost of goods and a key customer loss created an opportunity for us to purchase shares in leading milk producer *Dean Foods*. With leaner corporate costs and less debt, post divesting its non-milk segments, management has a focused and well-articulated plan, including further cost savings. If only 50% of the cost savings are realized we estimate fair value at $19, 30% higher than the prevailing share price.

Northern Tier Energy (NTI) operates a 90,000 barrel per day refinery in Minnesota and owns various petroleum storage and transportation assets along with a chain of convenience stores. The location of the refinery creates a feedstock advantage, benefiting from easy access to light, sweet Bakken crude, which translates into higher margins than most of its peers. We suspect that NTI will eventually become wholly owned by Western Refining, a larger more diversified company that currently owns 38.7% of NTI. Though structured as a master limited partnership, we entered our position by selling puts (collecting proceeds) and buying calls (spending the put proceeds). In this essentially cashless transaction we are able to wield many more calls than puts because, unusually, the call premiums were about half the put premiums, with less downside risk too as the put strike is 10% below the share price. And, neither expire until early 2016 so we have time to wait. NTI's replacement value is in the low $30s per share range, and a takeout could lift the shares by approximately 30%. The leverage from our synthetic position would provide an even higher return.

Weatherford International is one of the dominant players in the U.S. domestic and international oil and gas services industry. Management is currently working to improve overall profitability through the sale of various non-core assets, which will also improve the company's balance sheet. Now that the U.S. rig count looks to have finally bottomed, U.S. margins for both drilling and pressure pumping are poised to recover in 2014. A margin recovery could potentially lead to multiple-expansion back to historic levels of almost 16x forward earnings (that we expect to grow nicely), the perfect combination to drive share price over 30% higher towards our $21 target.

Technip, headquartered in Paris, France, is a global company that provides project management, engineering, construction and installation for the energy and chemicals industries. We initiated a position after a downward revision in guidance that reset expectations to more realistic levels. However, with a book-to-bill ratio above one (the backlog has reached approximately €16.6 billion) and a clean balance sheet, Technip is solidly positioned and attractively priced well below its normal trading range and our estimate of its fair value. With expectations extremely low, when the company recently reported in line 2013 results, but strong operating cash flows of €871.8 million and a 10% dividend bump to €1.85, the shares responded positively and look to move higher as the company continues to deliver on its forecasts.

Global Insight (Large Cap) Portfolios – Key Holdings

Through December, our Global Insight Long/Short Model (our entirely large cap model) is up 11.7% (USD) and 13.8% (CAD) annualized since inception June 1, 2012, net of all fees. A complete description of the Global Insight Model is available on our website.

Our target for our larger-cap positions is more than a 20% return per year over a 2-year period, though many may rise to our FMVs sooner should the market more readily recognize their undervaluation. And, some may be eliminated sooner if they breach TRAC™ floors.

Too Big To Hide

Our *Goldcorp* position has performed well since December along with the price of gold. As one of the lowest-cost senior gold producers (all-in sustaining cash costs below $1,000 per ounce), Goldcorp is well positioned to grow. Its 2014 gold production should grow by about 15% to over 3.0 million ounces. Assuming the gold price strengthens toward $1,450 per ounce (just below the current marginal cost of production for the industry), the shares should move towards our net asset value in the low to mid $30 range.

The corporate breakup continues to proceed at *Vivendi* and we remain committed to our sum-of-parts valuation which is 25% higher than the share price. With Activision and SFR divested, we see the potential for the remaining Vivendi assets to be re-rated above our conservative multiple due to their higher ROE and growth potential.

We recently purchased shares of teen retailer *American Eagle*. The company's Chairman and interim CEO did too, in size, which is typically an excellent sign. With net cash representing 15% of the company's market capitalization and the stock selling at 75% of our $19 fair value estimate, we are less concerned with the near term sales uncertainty resulting from the poor weather. The company's brand remains relevant within its key demographics and the plans for further international growth continue to be a source of potential upside.

EMC, a provider of enterprise storage systems and server virtualization software, continues to tread water. There are several reasons behind its middling performance: concerns from international customers over NSA access to U.S. based technology providers; a deceleration in storage revenue; and recently issued guidance that was slightly below expectations. We still estimate a $30 FMV. New product cycles for VNX2 and XtremIO and continued success of its VMAX offerings should lead to market share gains and accelerating growth.

We continue to believe that *Apple's* current fair value is above $650, implying more than 25% upside potential. Our Apple valuation model is conservative, assuming very harsh average selling price declines and decelerating growth rates for its major products. Furthermore, our model does not factor in new products or services that have been long rumoured such as the iWatch, iTV, or enterprise iPad variant. CEO Tim Cook keeps suggesting truly revolutionary products are in the works.

Other than delivering a solid quarter of earnings, nothing has really changed at *Madison Square Garden.* The owner of the New York Knicks and Rangers sports franchises, sports and entertainment arenas and the sports cable network, of the same name, still trades at a compelling discount to our sum-of-parts valuation. Trading just over 70 cents-on-the-dollar of that valuation, the stock is compelling. And, we don't rule out a Dolan family (the controlling shareholder) takeover should the market's lack of appreciation for the shares continue.

CST Brands is a major convenience store chain that was spun out of refiner Valero last year. Analyst coverage is weak and the company trades below our estimate of its fair value, at 80% of our $40 fair value estimate. The company recently slightly lowered its quarterly guidance but the transition to higher margin general merchandise sales remains on track. Initiatives to open new larger stores with more focus on higher margin products remain in place while also shifting away from lower margin cigarette sales at existing stores by dedicating more selling space to fresh food.

TRW Automotive Holdings is among the world's largest and most diversified suppliers of automotive systems, modules and components to the global original equipment manufacturers. The company is in a sweet spot in the industry, primarily focused on safety products, including braking and steering, airbags and seatbelts and electronic control units including crash and occupant weight sensors. Since Northrop-Grumman acquired TRW in 2002 and subsequently floated the automotive operations in 2004, TRW has been a deleveraging story in a recovering industry. TRW has used its free cash flow to reduce net debt down to only $385 million and returned $520 million to shareholders through share repurchases in 2013 alone.

After buying and then selling TRW last year after it hit a ceiling in our work, we have again built a position in TRW, buying the stock at approximately 8.5x forward earnings. Despite the attractive valuation, the company is firing on all cylinders and just recently reported excellent financial and operating results. Although the shares have again rallied, additional upside is possible based on our assessment of fair value.

Continental Resources is one of the largest oil producers from the Bakken formation and is the largest leaseholder across North Dakota and Montana. The company's strategy is to optimize and enhance recoveries through down spacing and the completion of horizontal wells in multiple, stacked zones in the well-known Bakken formation. The company produces approximately 150,000 boe/d and for 2014 production is expected to increase by at least 25%. Its proved reserves increased 38% last year with about 70% weighted to crude oil. The value of the proved reserves is now in line with the current market cap of the company, though upside should still come from the probable reserve category, down-spacing throughout the basin and the SCOOP oil and liquids-rich play (currently accounts for approximately 20% of proven reserves but grew at 241% in 2013 from 2012). We may exit our position shortly as the price has risen close to our FMV estimate.

The current market environment, defined by low interest rates and low volatility, has pressured *Credit Suisse Group's* net revenues and capital markets activity. In response, CS has been refocusing on private banking and wealth management. A combination of cost cutting and growth initiatives should see CS's ROE hit 14% by 2015. Meanwhile, at current share prices, investors are getting CS's Investment Banking division for almost nothing. Using conservative multiples, our sum-of-the-parts valuation of CS's private banking and wealth management business alone is close to SF26, implying investors are paying just SF2-SF5 for the Investment Banking division depending on the multiple ascribed. In a better capital markets environment, the Investment Banking division could be worth SF10.

In the last few months a number of positions were sold as they rose to our FMV estimates or inflected down from TRAC™ ceilings, including: National Bank of Canada, Hewlett-Packard, Qualcomm, ING US, Phillips 66, Suzuki Motor, Corning, Juniper Networks and Deere & Co.

A few fell below TRAC™ floors and were sold to avoid further potential declines from those levels: Samsung, China Unicom, Ensco, China Mobile, Triumph Group, Standard Chartered and Abercrombie & Fitch.

Other new additions in the period included *Dean Foods*, *Baker Hughes*, *Apache*, *Deutsche Bank*, *Total*, *Tesco*, *Randgold*, *Yamana Gold*, *Guess?*, *Orange*, *Newmont Mining* and *Northern Tier Energy*—all at floors and at least 20% below our FMV estimates. Some are detailed above in the All Cap Portfolios section.

Income Holdings

Interest rates have risen and ranged between 2.5-3% in the last few months. High-yield corporate bond rates increased from a record low around 5% to yield over 7% last fall but are now back down to 5.6%. Our holdings have an average current annual yield (income we receive as a percent of current market value) of over 7%—a bit lower than last quarter due to the cash we hold and some price increases, particularly our Specialty Foods position which is an equity-linked security.

Last quarter we noted experiencing more volatility than usual in our income positions as November went in the wrong direction. In the last 3 months the volatility has continued but it's been positive. The prices of our bond/debenture holdings have since rebounded nicely. A few still trade well below par value but we still have favourable views of these positions and therefore we continue to hold them based on their asset coverage which, we believe, justifies much higher prices. And we continue to collect outsized interest income based on the depressed prices.

We look for income opportunities where interest 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). However, we have been holding more cash than usual as low rates, particularly in high yield securities, have created a dearth of attractive opportunities. We will continue to explore for opportunities (both via screening and our network of contacts) and patiently await better risk/reward parameters.

The *Advantex* debentures we held matured and we purchased units of Advantex comprising secured 12% debentures maturing in September 2016 and common shares. At a minimum we should earn 12% per year in interest with minimal risk of capital loss as the debentures are secured by receivables of the company. And, if the company grows as we expect and/or gets acquired down the road, our return should be even higher from the capital appreciation of the shares.

Our Smith & Wesson bonds were called by the company at a healthy premium. We sold our Thompson Creek bonds after they lifted in price (leaving the yield less attractive) and the company's earnings disappointed. We sold our Brigus bonds too once they lifted essentially to par value—in line with where the bonds will likely be called (from the change in control provision) once the company's buyout closes shortly.

Of note, regarding our top income holdings: *Specialty Foods Warrants*, a private company held only in our taxable income accounts, is expected to return capital to us later this year (see the reference under All Cap holdings above); *IBI Group*'s convertible debentures should be restructured shortly and the company's free cash flow underpins value; *Retrocom REIT*'s price still doesn't reflect the underlying net asset value which is growing from optimization of its real estate portfolio*; Pitney Bowes* preferreds have benefited from its improved bottom line; *JC Penney* bonds are due in October of next year and while the operations have somewhat improved, there's ample liquidity and its owned real estate provides comfort too; *Brookfield Real Estate Services* was able to bump its dividend because of its steady royalties based on the increasing number of real estate agents in its network; *Ruby Tuesday*'s operations have slightly worsened but its bonds are well covered by underlying real estate and free cash flow; *Armtec Holdings* bonds have been stable because the company's turnaround has delivered better profit margins.

Seeking Performance From Hidden Treasures

Interestingly, even as we have been increasing our weighting in larger cap companies, our Canadian smaller cap companies seem to have finally bottomed and are doing better, and we believe could be on the verge of finally rewarding us significantly. Contrarian opportunities for sure. They are being helped by better energy and metals prices, by the declining Canadian dollar, by their improving business prospects, but most of all by a recent market awareness of their undervalued nature. These include Manitok, Corridor, St Andrew, Dynacor, Orca and Legacy. Interestingly the TSX Venture Exchange, the proxy for small cap resource Canada, is finally lifting off its floor. The weak loonie could make many of these takeover targets by foreign buyers too. 2014 could be a much better year for those very cheap companies, and for us. Then, hopefully, we won't have to hide, and will be sought.

Herbert Abramson and
Randall Abramson, CFA
February 27, 2014