TRAPEZE
ASSET MANAGEMENT

THROUGH OUR EYES

In the brilliant musical “Cabaret”, the emcee of the nightclub, dancing affectionately with his amicable gorilla mate, sings “If you could see her through my eyes.” We feel like that emcee. With each of our recent investment letters, despite the ugliness in Euroland, slowing emerging country economies and in the developed world too, we have continued to note the attractiveness of stocks compared to other asset classes. And the particular cheapness of our own portfolio. Yet, the quoted prices get cheaper, frustrating our already exercised clients and us, but making the portfolio holdings even more attractive, with even greater potential.

How ironic, and needlessly stressful for you and for us, that even as the businesses and the fair market values (FMVs) of our portfolio holdings improve from already attractive levels, their share prices decline from negative sentiment. Would that we could report only those rising FMVs instead of their quoted prices. Every investor thinks their stocks are cheap. But there is cheap, and there is absurdly cheap. The share prices of our energy and gold holdings have languished. Even though oil and gold prices remain high, the stock prices keep getting cheaper, stretching the rubber band. In our case the amicable gorilla is a snorting, raring to go, bull. Value, like beauty, is often in the eye of the beholder. If you could see it through our eyes.

Investors are exceedingly fearful, understandably, from the relentless negative economic news focussed on potential sovereign debt defaults, banking crises, global recession, U.S. “fiscal cliff” ($4 trillion of expiring tax cuts and automatic government spending reductions), and assumed ineffective policy responses. And, of course, the uncertainty from the upcoming November presidential election.

Whenever the “risk off” bell goes investors dump stocks, momentarily unpopular. So, investors have responsively continued to sell cheap stocks to hide in expensive bonds. Warren Buffett has said that, with their current purchasing-power risk, “bonds should come with a warning label.” So much for “risk off”. The dividend of over 2% on the S&P 500 has exceeded the 1.5% yield (a negative real yield) on the 10-year U.S. treasury for a historic number of days. Money continues to flow from equity funds to money market and bond funds. And fund redemptions have continued to pressure stock prices, unjustifiably, sometimes indiscriminately when managers have to sell even their favourites to meet those redemptions. But because the selling is finite, prices tend to go up when the selling is done.

Inflection Point

As we, no doubt, have previously noted, the current flight from cheap equities to expensive bonds during this low inflation period is the exact opposite of what was occurring in the early '80s, just before the reversal. In October 1982, despite a 22% prime rate in Canada, 16% mortgages and an 18% yield on the 20-year 2002 Canada bond, investors shunned cheap, extraordinarily high yielding, safe bonds, instead preferring equities, fearing that then high inflation would continue, even as the Fed Chairman Paul Volcker was putting on the brakes.

We said then, business doesn't work with a 22% prime rate, houses aren't affordable with 16% mortgage rates and equities can't compete with an 18% 20-year government bond. Stocks then, as a percentage of household assets, were only 11% (down from 35% in 1965) and are now 20% (down from 37% in 1999). That was the inflection point, the beginning of the 30-year bull market in bonds, today a bubble in bonds (from what has been described as a "bubble in fear"), that we believe is about to end.

While the central banks in the '80s were putting on the brakes, today they are pedal to the metal. Because, as they have in the past, politicians tend to compromise in a showdown, the U.S. fiscal cliff may turn out to be a bungee jump. While excessive fiscal debt and deficits need to be addressed and are, monetary policy everywhere is accommodative, to keep borrowing costs low and the quantum of money high. To stimulate economic activity and avoid deflationary pressures. U.S. money growth is about 10% annually and, if need be, QE3 is in the cards. "Money makes the world go around."

China, India, Brazil and others are all taking steps to revive their slowing domestic economies. China and the ECB just lowered interest rates and Britain loosened monetary policy. With all this stimulative policy effort, recovery, modest though it may initially be, is likely to follow.

It isn't just respectable and rising dividends that make stocks attractive. Their earnings yields are too. The S&P 500 earnings yield (earnings as a percentage of price) of 8%, compared to paltry treasury bond yields of 1.5% for the 10-year and 2.6% for the 30-year, is exceedingly attractive. Although Q2 earnings estimates are down (75% of earnings reports for Q2 thus far have beaten those estimates), U.S. corporate earnings are still at a record high and growing, though more moderately. In fact, corporate profits are the largest percentage of GDP ever. Imagine, record high corporate earnings compared to record low interest rates. And, remember supply and demand? While the quantum of bonds is relentlessly increasing, the quantum of stocks available to buy is actually shrinking—from share buybacks, M&A activity and the scarcity of new issues. Corporate cash on hand is high allowing for buybacks with some even using cheap debt to fund buybacks. And money on the sidelines in the U.S., to purchase shares whenever the "risk on" bell goes off, is at a record high, some $9 trillion, with almost $2 trillion held by nonfinancial U.S. corporations. Margin-debt growth is zero, reflecting investor nervousness. Cash as a percentage of GDP is at a record high. Buying power.

Improving Indicators

Unquestionably, there are things to worry about. Job growth has been anemic. But that's a lagging indicator. The public sector job growth has been declining as governments need to rein in spending. And modest private sector job growth is restrained from corporations wary of those same scary headlines. Importantly though, small business hiring plans over the next several months are improving—a good long-term indicator.

But there is other positive news. We continue to focus on the attractiveness of U.S. housing, from record affordability, low prices, 30-year fixed mortgage rates at record lows, improving existing and new home sales and declining inventories. Home prices in the largest metropolitan areas have begun to rise. Unsold inventory of new homes is at the lowest since the early '60s. And rents are at record highs, an incentive to buy, if the renter can get a mortgage, not an easy task today. But it is now cheaper to buy a home than to rent.

U.S. homeowners' equity rose 7.3% in Q1 to $6.7 trillion, the biggest increase in 60 years, with homeowner equity representing 41% of residential-property value, the most since '08 when it reached 43%. We emphasize housing because home ownership is such an important component of consumer net worth and spending potential, and because new home construction, still low but improving, is a major potential contributor to higher employment.

Perversely, while June U.S. manufacturing numbers were weaker, mainly from weak exports, U.S. auto sales continue to improve, with Chrysler having its best June in 5 years, GM's June U.S. sales up 15.5%, almost twice the estimate, and Volkswagen's up a whopping 34.5%. The best first half for vehicle sales since 2008, likely from years of pent-up demand.

And U.S. housing starts in June were up 6.9%, the highest rate since October '08. Despite the better new home starts and auto sales, overall U.S. retail sales in June were disappointing and U.S. consumer sentiment declined in July from concern over finances and job prospects, even though, paradoxically, the consumers' view of their current economic situation rose. While unemployment is a lagging indicator, the stock market is a leading indicator, and as it improves, with improved housing too, so will wealth and confidence and the overall economy. Retail prices of gasoline have been decreasing recently giving the consumer more to spend. And consumer spending accounts for about two-thirds of the economy.

While investors focus on scary European debt, in the U.S., despite rising government debt, since the recession ended in '09 total U.S. debt has risen at the slowest pace since the early '50s from the massive deleveraging in private sector debt. As a result, total debt to GDP has fallen from 3.7 times GDP to 3.4 times. While public sector debt is up—to 89% of GDP from 56%, U.S. household debt has fallen to 84% of GDP from a peak of 98%, nonfinancial corporate debt is down from a peak 83% of GDP to 77% and financial sector debt down from 123% of GDP to 89%. U.S. households' balance sheets are clearly improving. Low levels of debt are essential to growth.

Big And Small "Perfectly Marvellous"

As we have previously noted, large-cap stocks, indeed the largest cap, dividend paying and steady growth stocks, have recently unusually outperformed small and mid-caps. And we have been embracing larger caps too that meet our value criteria, which most did not prior to the crash in '08. Because of their liquidity we can opportunistically trade them too. But the smaller caps we hold are still, by a large margin, the cheapest with the highest potential—many of them, in our opinion, absurdly cheap. And, which we believe will ultimately be highly rewarding. We merely need to have more patience. The TSX Venture Exchange Index, our proxy for Canadian commodity small-caps, trades near 9-year lows, despite much higher commodity prices currently. And after a 20% decline year-to-date, the TSX Venture Exchange is now 65% below its high of 5 years ago.

Though the smaller cap companies clearly present greater risk in terms of their volatility and liquidity, common sense would suggest bargains abound. In our own portfolios most of the stocks trade well below our appraised values—a disconnect which is frustrating in the short run, but which we believe should inevitably provide gratification.

If the reward doesn't come through the typical demand from investors, it will likely come otherwise—through normal course issuer bids, corporate buybacks, mergers and acquisitions, including even, privatizations. You had better believe that frustrated managements of severely undervalued companies are focussed on extraordinary mechanisms to raise share prices. Our largest position, small-cap Manitok Energy, trading at less than 1.5x 2013 cash flow, just implemented a normal course issuer bid to buy back its shares. Others are sure to follow. Moreover, recent insider buying is strong—the most knowledgeable buyers really get it and tend to outperform the market for the 12-month period after buying.

Our Top Holdings

If you could see it through our eyes, you would see our companies trading at levels far below our FMV estimates. And it's not like we're wearing rose-coloured glasses. Most of the companies have been reporting record results. But the market, distracted by concerns over the global economy, has chosen to ignore positive results, particularly in the case of the smaller cap resource companies.

However, as our holdings continue to add value, they will be difficult for investors to ignore, many of our holdings already trading at merely a fraction of our estimated appraised values. It's hard to imagine that with even higher values the stock prices, over time, aren't heading higher too.

Manitok Energy trades at less than half of our appraised value of more than $3 per share, over twice its share price of $1.37. Guidance of over $50 million of annualized cash flow at year end, on nearly 4,000 bbl/d of production, should push the value to about $4 per share, rising even further as the production and cash flow over the following 2 years likely more than doubles.

Others are starting to take note, 7 brokerage firms now with buy ratings. In its most recent monthly small-cap compendium, CIBC Wood Gundy has Manitok as its focus stock. Yet the share price remains depressed as market participants remain fearful and myopic.

Manitok has an experienced team, a combination of land assembled at cheap prices and long-life reserves providing very attractive IRRs (internal rates of return), oil focussed development drilling and a track record thus far of no missed wells.

Manitok is so mispriced that, at this year end, if it decided not to grow but merely drill 3 wells a year to subsist, it would still have free cash flow of around $35 million (at $85 oil) each year. With an equity market cap of only about $85 million, that would constitute a 40% earnings yield. But we do expect the company to drill at least one well per month for the next few years which should boost the underlying value. In just 3 years' time Manitok should have annual cash flow per share (assuming $85 oil) which exceeds today's share price. And at 4-6x that cash flow (where peers trade) we believe the share price should then be 4-6x today's level.

St Andrew Goldfields production just hit a record 23,000 ounces for Q2 '12 and appears on track to produce about 100,000 ounces in 2012, with further growth ahead. Cash flow should be about $0.13 per share for 2012 and higher in 2013 from growing production. Our target in 3 years is over 4x the current share price (at an 8x cash flow multiple and assuming even a lower gold price of $1400). At the current price of gold, based on our production estimates, St Andrew could have more cash in 3 years than its current share price—that is, we'd be getting the entire business free—a business that's now earning about $50 million pre-tax annually. Because we can't conceive the market valuing the entire mining operations and other assets (including its massive land package) at zero, we anticipate a significant lift in St Andrew's share price.

Like Manitok, the key risk for St Andrew is a decline in the commodity the company produces. However, as in the case of oil, the price of gold is also "on buy" in our work. And, with real interest rates (with which gold most highly correlates) likely to remain negative for some time, gold is probably headed higher in the near term.

St Andrew's business is accelerating—resources are expanding, production is ramping up, costs are declining and profits are expected to be at record levels. Yet the stock is priced at less than book value and less than one-third of net asset value. As gold bullion lifts and the recently depressed gold mining group recovers, we foresee a substantial lift in the share price.

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-quarter of our appraised fair value. The perception of political risks has escalated since late last year as the company has been dealing with various government bodies in Tanzania with some pressure to revise its production sharing agreement. Meanwhile, the government has signed an agreement with a Chinese sponsored group to build a major pipeline (to be completed in late 2013) and major oil companies have made multi-Tcf discoveries in the region which should spur the long-term government plans to enhance gas-fired power generation and LNG production for export. Orca's production and cash flows are already at record levels and the new pipeline should allow a ramp-up of production. As well, the company announced recently a significant development well which should produce in excess of 40 mmcf/d.

Our appraisal of over $8 per share is mostly derived from current reserves. The company has temporarily deferred its exploration drilling of Songo Songo West until it clarifies issues with the government. Meanwhile, onshore exploration drilling in Italy next month could add materially to the net asset value. The recent lifting of the moratorium on offshore drilling should also allow Orca to drill its other Italian property sooner too.

Orca has long-life reserves, operates at low costs with high netbacks and the company'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 3 times its current share price, perhaps much more depending on further drilling success.

OfficeMax's share price has been volatile moving both up and down merely on shifts in sentiment. The $7 billion revenue company with 19,000 employees and operations in 4 countries, including about 1,000 U.S. retail locations, is dependent on small business formation to spur top-line growth.

While the company's market cap is about $400 million it has non-operating assets, on and off balance sheet items, of $180 million (including net cash of $125 million). We are essentially paying just $220 million for the current free cash stream of $60 million annually or about 3.6x free cash flow. Management has cut operating costs and provided 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. Our estimate of FMV is twice the company's current share price, growing to more than 3x over the next 3 years.

Pivot Acquisition is one of two private companies we own in our taxable accounts. The security we hold in this IT outsourcing company is a 12% convertible debenture. We collected 22% in the first 12 months we owned it, including the 12% coupon and 10% extra penalty interest for Pivot not having met its initial IPO timeline. The company is working hard toward a liquidity event (likely an IPO) prior to the next penalty date in October.

As a private company Pivot's securities are not listed, so the debentures are subject to liquidity risk, which we believe is well compensated for by the premium yield and favourable conversion privilege.

Pivot recently acquired another similar small IT company and more potential accretive acquisitions should be available. The company should have over $50 million of EBITDA this year and we believe could double that over the next 3-5 years, even without acquisitions. If we assume a 5x EV/EBITDA multiple from an IPO valuation, making Pivot's total enterprise value $250 million, because the debenture's equity conversion price is 50% of its IPO price (if and when that occurs), that potentially provides a large lift over our existing carrying value of par for the bonds in addition to the 12% coupon while we wait.

Specialty Foods, our other private company holding, is the manufacturer of Nathan's Famous hot dogs, the leading hot dog brand in the U.S., along with other packaged meats. We own debentures plus warrants which can be exercised into equity. One-third of the principal amount of our debentures was repaid on June 30, but we retain all of our warrants. The company is having an excellent 2012, with sales up and costs down.

We believe the warrants should be worth much more than our carrying value because our estimate of the equity value of the company greatly exceeds the debt. Based on the company's annual free cash flow expected over the next 2 years, we estimate that the total value of the bonds and warrants could be as much as 75% more than our current total (debentures plus warrants) carrying value. 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.

Corridor Resources may begin to see the benefit of a recovering rising natural gas price. Prices have begun to rise through a combination of: warm weather; less capital allocated to gas projects evidenced by the fewer number of gas drilling rigs in the U.S. which has collapsed from over 1600 in 2007 to just 522; significant switching from oil and coal to natural gas—for the first time in history gas used by power utilities in the U.S. equals that of coal; and a likely demand increase from a growing economy and various initiatives such as the use of compressed natural gas for transportation and the construction of LNG facilities to export gas to foreign markets where gas prices are dramatically higher.

Meanwhile, the company continues to work hard at landing partners for its 3 mega projects: its Frederick Brook shale gas field, 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 shale oil project, on Anticosti Island, Quebec, with 19.8 billion barrels of oil equivalent resources in place; and its Old Harry project in the Gulf of St. Lawrence with a potential 2 billion barrels of recoverable oil. Each one of these projects has the potential to provide material upside for Corridor's share price.

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

We believe the risk-adjusted net asset value remains well above the current share price. While the timeline is uncertain because the company needs partners, we believe the longer term risk-reward ratio remains very favourable.

MetLife is a dominant international life insurance franchise which trades at less than 6x earnings. Low interest rates have negatively impacted most life insurers' earnings. Our FMV estimate is over 50% higher than the share price, and it is growing. Like our other large-cap holdings, we are looking for a potential return to fair value in excess of 25% per year over the next 2 years.

Legacy Oil + Gas was a new addition for us last quarter. We sold about one-third of the position in reaction to a TRAC™ sell signal in early June at about $6.80 and just repurchased shares at about $4.90. The company is a light-oil producer with assets in Alberta, Saskatchewan and North Dakota. At its current price, Legacy is trading at half of its net asset value. We can find no reason for the extreme undervaluation other than concern over lower oil prices or perhaps fund managers having to sell to meet redemptions. More than 85% of Legacy's production is light oil and the company has an enviable 100% drilling success rate. Even at only $85 oil, netbacks remain high at around $46 per barrel.

We believe the recent price decline so far below fair value is unwarranted. Moreover, Legacy should continue to grow by over 25% per year as it taps into its 1,200 net drilling locations. At $85 oil, we anticipate our FMV estimate may rise to over $20 in 3 years—a target which implies a 4-fold return.

New Additions

We have added shares of several larger cap companies—*Abercrombie & Fitch* (8x earnings), *Oracle* (7x earnings, net of cash, based on our cost), *Google* (10x earnings ex its cash hoard), *Och Ziff* (6x earnings with a noteworthy 5.4% dividend yield) and *Aetna* (7x earnings)—as each fell to a floor in our TRAC™ work, trading at wide discounts to our estimates of FMV. Each was purchased after a comprehensive business analysis but initially appeared amongst the most undervalued stocks on our screen of about 1,000 global large-cap companies. And each met our hurdle rate of a potential annualized 25% 2-year return.

We reduced our positions in *Fortress Paper, Southern Pacific* and *Dell* in reaction to TRAC™ sell signals. But with each having subsequently declined to a lower TRAC™ floor, we now see even more potential upside.

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 8%. The yield 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).

Of note, regarding our top income holdings:
Specialty Foods, as mentioned above, continues to deliver, with one third of our bonds having been repurchased by the company according to schedule; *Advantex's* profits continue to grow as it expands its merchant base; *Pivot Acquisition*, also mentioned above, is working towards a liquidity event; and, *Smith & Wesson* bonds have jumped in value with the rise in the company's profits.

Recent new additions include *Allied Nevada* 8.75% June 2019 and *NII Cap Corp*. 8.875% Dec '14/19. Allied Nevada is a U.S.-based intermediate precious metals producer whose staged expansion is expected to triple gold production to over 300,000 ounces by 2013 and double again by 2015. It is cash flow positive today, with $275 million of cash on the balance sheet plus additional significant excess potential liquidity. These Canadian dollar based senior notes provide a yield to maturity of 9%. NII Capital is the funding arm of NII Holdings Inc. whose mobile communications business is focussed on Brazil and Mexico. The notes fell into our buy range as the market has become overly fixated with the current short-term noise surrounding NII's network upgrade and potential impact on market share. At 92 cents on the dollar, and a 10.3% yield-to-maturity, we believe we are well compensated for any near term uncertainty as NII's spectrum and other replacement value cover all its outstanding debt nearly 2:1.

"Maybe This Time"

While Europe is clearly in a recession and Asian growth is slowing, our econometric model (TEC™) shows no sign of an impending U.S. recession. Indeed, from Bernanke's recent congressional testimony, neither does the Fed. The highly favourable monetary and valuation conditions continue to act as downside shock absorbers. Our other proprietary methodologies still show green lights for the markets 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. In our last letter we noted the S&P 500 had risen to a stretched 20% above the TRIM™ line suggesting a pullback or perhaps a few months of sideways action. Through a combination of time and market correction, the overbought level has alleviated.

We have employed some defensive measures periodically to address concerns about the possibility of a negative macro event, recently buying stock index put options (in option authorized accounts) to protect from an unfavourable Euro event (and urge our clients who have not done so already to speak to your portfolio manager to authorize us to trade options so that we can use defensive strategies in your accounts). As well, in long/short accounts we hold a few short positions of stocks we believe are overvalued, which could serve as a partial hedge in any market decline.

"Come Hear The Music Play"

Investor sentiment has recently been at the greatest level of pessimism of the last three years. But the market should start to ignore disappointing news that's already "in the market", and start to invest for the recovery for which policymakers strive.

Goldman Sachs, in a detailed report, stated they believe the prospect for returns from stocks relative to bonds are as good as they have been in a generation, largely based on valuation from the erosion of investor confidence in stocks. This should not continue. Most of the time the market is efficient and stocks trade at their fair value. In the absence of unforeseen events, the prices of our stocks are likely to ascend to be more in line with those fair values, particularly as value continues to accumulate on our companies' balance sheets in the form of cash or net assets.

James Paulsen, Chief Investment Strategist at Wells Capital Management, believes the S&P 500 could be up 50% in 5 years if confidence normalizes. And he believes this is an extraordinary buying opportunity not seen since the 1970s. We share that view. Confidence will return and stock prices (and interest rates) will rise. And investor patience will be rewarded.

Herbert Abramson and
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