TRAPEZE
ASSET MANAGEMENT

EMBRACE BOTTOM UP

No, we're not being lewd. We are suggesting that with all the conflicting macroeconomic news, some good, some not, and with the S&P 500 and the Dow at new highs while many sectors languish, it is preferable to focus on the little picture not the big one. The big one may currently be more unpredictable than the small one, being bottom up investment in undervalued securities. Those may currently be less popular, but we value investors are naturally driven to buy investments low, that are neglected and unpopular, with the view of selling them high when their popularity is enhanced. Buy low and sell high. Not buy high and sell higher as is now in vogue.

The Big Picture

The news from the world's largest economies is mixed and the outcomes are not clearly predictable. Our proprietary TEC™ and TRIM™ work, which is designed to alert of significant economic and market downturns, is not forecasting anything dire ahead that would warrant undue caution. But whether growth accelerates or continues at its current sluggish pace is unclear.

In the U.S., the world's largest economy, some recent news has been good. Q2 GDP at a 1.7% annual rate was better than expected but still below historic rates, and while consumers kept spending and business investment was somewhat higher, GDP was probably pushed higher from rising inventories and a smaller June trade deficit. Still, GDP growth remains the slowest of any expansion since 1948.

U.S. factories in July had their best month in 2 years as the ISM index jumped to 55.4 from 50.9 in June, the biggest 1-month jump since 1996. New orders were at a 2-year high from the recovering housing market and the demand for autos, auto sales being the strongest since late 2007. But with higher mortgage rates making consumers more cautious, U.S. consumer sentiment declined in August from a 6-year high in July.

Even with an improving picture, because growth is subpar, outcomes are uncertain. While the jobless rate in July fell to 7.4%, the number of new jobs at 162,000 was below expectation; many in the work force no longer looking for jobs and no longer being counted, and many Americans working fewer hours in July and their average pay declined. Part-time jobs increased more than full-time ones. Full-time employment is at a historically low 47%. In fact, since '07 part-time jobs are up while full-time jobs are still down. Opportunity for youth is diminishing. A strike at McDonald's. A Big Mac but a Small Deal.

Subpar growth. Though new and existing home sales in the U.S. have been rising, and house prices too, the home ownership rate at 65% is declining. With the recent rise in mortgage rates (up a full percentage point since May) and higher house prices, housing is becoming less affordable. Younger first-time buyers are being left behind and lenders are becoming more cautious.

After a decade of declining median income, the consumer's standard of living is back at levels of 25 years ago. Four years after the recession ended in '09, per capita output and incomes are still below the pre-crisis highs. On the plus side, household balance sheets have improved considerably, and still hold some $9 trillion of cash. And consumers are borrowing more to spend on autos, homes, and other goods. However, recent consumer sentiment has ebbed somewhat, and weaker sales at Macy's and Wal-Mart may be indicating continued weakness in the economy.

Tug of War – Austerity vs. Stimulus

The U.S. federal deficit has, thankfully, stopped rising, from the sequester which caused federal spending and debt to grow more slowly, but the debt of $17 trillion is about equal to GDP and, believe it or not, this ratio is higher than most of the beleaguered and bankrupt Eurozone economies.

Core inflation, most recently at 1.6%, has been low and that, plus the subpar growth, has led the Fed to keep its easy monetary policies in place. The mere hint of reducing, of so-called "tapering", monetary ease and the massive bond buying by the Fed, creates urgent selling in the bond market, and gold too. Bernanke retiring and the uncertain intentions of his successor are causing angst too. In our last several quarterly letters we have forecasted the end of the bond bubble, the 30-year bull market in bonds, and it looks as though that macro forecast will be proven correct. Interest rates have been rising and bond investors have suffered.

Subpar growth is causing local governments to struggle. Detroit's bankruptcy is the largest municipal bankruptcy in U.S. history. Others may follow. Many school systems are in crisis.

Other Economies

Meanwhile, the world's second largest economy, China, appears to be slowing, from slowing foreign and domestic demand, with its growth rate approaching 7%, down progressively from almost 12% in 2011. Subpar growth for it. In response, China is implementing new stimulus measures to boost the economy, liberalizing lending rates to avoid a continuing cash crunch, eliminating taxes on small businesses, reducing costs for exporters, paying for new infrastructure projects and cutting excess production capacity. Recent trade data showed some improvement.

Japan, the world's third biggest economy, after almost two decades of deflation, is working hard to grow its economy even as Europe is stagnant and China slowing. This, through government spending, easy money and structural changes to the economy. With its government debt at almost 250% of its GDP, much larger than the U.S., if growth doesn't occur but interest rates rise, the economy could suffer. Happily, thus far, Abenomics seems to be working, with the Yen down 20% making its exports more competitive and its previously languishing stock market is up about 60% in a year. Housing starts are up as house prices have stopped falling, consumer sentiment is rising and, thankfully, so are prices. But economic growth, as elsewhere, is still subpar, with weak capital expenditures, making an overall recovery tenuous if the plan falters.

Europe is on the mend and just now recovering from its prolonged recession, but its recovery is expected to be slow and its debt crisis far from over. The EU's unemployment rate just fell for the first time in almost 3 years. Germany, its kingpin, saw unemployment drop unexpectedly for the second consecutive month. And Spanish unemployment, which at 26.3% is still frighteningly high, fell in July for the fifth straight month. Similar to the U.S., Eurozone inflation for next year is anticipated to be 1.3%, below its 2% target. And consumers are still pessimistic, though their confidence rose in July from June for the eighth straight month. The Euro holds up well but likely will go lower. All economies prefer a lower currency these days, to stimulate exports and prevent deflation.

We won't even get into the turmoil in the Middle East. Nor the struggling economies of India, Brazil, Mexico and Russia. And, while global manufacturing has been advancing somewhat, the IMF has lowered its forecasts for next year for the U.S., European and Chinese economies.

Top Down Uncertainty

Moving down the macro scale, while interest rates have risen, monetary conditions are still bullish. Inflation is not yet a risk. Indeed the Fed, concerned about the low level of inflation, would like more, at least 2%. We believe more is ultimately coming. Maybe much more, from the huge monetary liquidity. With little growth, nearly all developed countries are engaged in monetary stimulus. A likely prelude to more inflation. Maybe stagflation. Bad for bonds, better for stocks and hard assets.

Bottom line, from a top down point of view there is lots of uncertainty about outcomes. Currency wars are in vogue and every economy would like a lower currency. As for corporate results, revenue growth is sluggish and profit margins, though at all-time highs, are under pressure. Cost cutting is the order of the day, but has its limits. And with the major averages at new highs and the U.S. safe-dependable consumer stocks overvalued (seemingly the equity proxy for bond investors), investors need to seek out undervalued assets and be patient until these neglected opportunities get recognized. And they will. We look forward to, and expect, a sentiment change that will induce investors to acquire those stocks with the greatest undervaluation, including the ultra-depressed Canadian small caps.

Good News is Bad News

Good news has become bad news, with the hint of interest rates rising from economic improvement sending rates higher and bonds, commodities and, sometimes, even many stocks lower. The 10-year treasury yield jumped to over 2.8% on improved jobless claims and higher consumer prices. High yield bonds which yielded a record low below 5% in May have jumped to 6.4%. Long-term bond prices have been falling for a year and the stock market has had a slight correction despite recent "good news". The markets have become Fed-dependent, addicted to administered, historically low interest rates. Well, if you don't know when interest rates will rise further, whether the global recovery will be sustainable, whether there will be more inflation, then it's time to seek more certainty from simpler, bottom up, value investing, i.e., seeking out securities which trade at discounts to their fair values. Value opportunities for contrarian investors.

Market Fully Valued

While the market indices are at new highs, revenues of S&P 500 companies (excluding banks whose profits have soared from cost cutting) are rising marginally, about 1%, and earnings growth is slowing too. Meanwhile, stocks in the S&P 500, at 15x next 12-months earnings, are at their multi-decade historical average, while the Value Line (1,700 U.S. stocks equally weighted) is closer to 19x, at or above fair value.

Given the lack of upside revaluation potential, unless stocks go to bubble-like valuations, we anticipate U.S. stocks will only return a modest growth of earnings and the dividend yields (now less than 2%). Therefore, bottom up matters. Selected stocks, those with either outsized growth or those trading well below fair value, can still provide potentially high rewards. These opportunities, with most stocks at or above fair value, are certainly harder to find now, but by screening our 1,000 company large cap universe we are managing to uncover attractive large cap stocks trading at discounts to our estimates of fair market value (FMV) and at floors in our TRAC™ work.

Market Correction

The U.S. market continues to be susceptible to a short-term correction. We expect the TSX to outperform the S&P 500, especially with the resurgence of commodity stocks. While cyclicals may revive, the safe dependables—consumer staples and utilities—have run up to unsustainable levels well above their FMVs and are the most overdue for a correction.

With no TEC™ (economic) alert and no TRIM™ (market panic) signal, we do not expect a recession or bear market soon. However, the Dow and S&P 500 are at ceilings in our TRAC™ work and are now above our FMV estimates and due for a bull market correction. To be defensive, we have raised some cash and maintained some short exposure (where authorized) by selling short overvalued individual stocks—those trading above our FMV estimates and at ceilings in our TRAC™ work, most already "on sell".

If a rising tide supposedly lifts all ships it sure doesn't apply these days to stocks in the commodities or materials sector. And, for sure, not to Canadian stocks nor, doubly so, for Canadian small caps. This rising U.S. stock market tide has seen Canadian markets seriously underperform. The S&P/TSX is up about 4% this year compared to 17% (23% in CAD) for the S&P 500. To be expected, because the TSX is 40% energy and materials. Poor performance, even with oil prices strong from record global oil demand. And even Canadian energy stocks are 40% cheaper than their comparable U.S. brethren. Shares of TMX, the company that owns the Canadian Exchanges, are down 4% in 2013 as a result of the lower trading volumes. Even worse, the TSX Venture Exchange, a proxy for small and micro cap Canada, is still down 24% year-to-date and 73% from its '07 high.

Finally though, after this unduly extended bleak period, there appear to be signs of a bottom. Gold and oil prices have just given buy signals in our work. Copper appears set to break out too. The TSX Venture Exchange just gave its first buy signal in some time and our small cap positions remain much more undervalued than even our attractive large cap holdings.

Our All Cap Portfolios – Key Holdings

Our All Cap portfolios combine 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. We have increased our large cap weighting and foresee a continuing increase. Our small cap positions are cheaper than the large caps, so far below our fair value estimates that our portfolios continue to hold a concentrated position in small caps.

Manitok Energy's drilling success—a perfect 16 for 16 thus far with drilling results above expectations—has been as good as it gets. With a reserve value in line with its share price, downside appears minimal. But the production and cash flow growth justify a higher value. Production could be as high as 6,000 boe/d in the next several months which implies an annualized cash flow run-rate above $70 million or $1 per share, implying a very low trading multiple.

Other than an unlikely decline in the price of oil, we see few material risks for Manitok. Most wells are free-flowing oil to surface (i.e., without fracking) and the company just added 5 potential locations from a new deeper zone at its main property—likely over $1 per share of incremental value that the market glossed over because it was focused on another already known new area which has yet to bear fruit.

Manitok is drilling at least one well per month which should keep driving value higher. Assuming $65,000 per flowing barrel (transactions to buy production have been taking place at much higher prices) Manitok has over $4 per share of value today and its value should grow to over $6 by the end of 2014, compared to its $2.78 share price today. Assuming $85 oil (likely too conservative given the tight global supply/demand situation), in just 3 years 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 3 times today's level.

Specialty Foods Group, held in our taxable accounts, has become one of our largest positions based on a June 30 third party valuation that priced our warrants (exercisable into equity) at more than double our previous carrying value. And they will likely be worth much more. The company had a superb 2012, adding to its cash hoard and won its lawsuit against Nathan's. The business continues to generate substantial free-cash flow. After the expiry of the manufacturing/distribution contract with Nathan's early next year, the company should be in a position to return capital in a tax efficient manner to its stakeholders.

St Andrew Goldfields has been delivering record production levels. However, the lower gold price and sentiment toward the entire group have held the shares back. The balance sheet has net cash (net of all debt), and the stock price is less than half of its net asset value, even using today's depressed gold price. We believe gold prices are unsustainably low, below the marginal cost of production (the cost to initiate the highest cost projects). While commodity prices can remain below their marginal cost of production (over $1,500 per oz. for gold) for a period of months, they rarely stay there for any lengthy period. We expect a recovery back above the marginal cost of production over the next several months.

The main risk for St Andrew is a sustained period of lower gold prices. We take solace in the fact that the price of gold bullion has already jumped 17% off its bottom. And St Andrew would have only modest losses if the gold price temporarily dropped below $1,100, the industry's average all-in cost of production which should serve as a strong support for prices.

Our 3-year target for St Andrew remains about 3 times the current share price, assuming a 6x cash flow multiple and somewhat higher gold prices that we believe to be reasonable.

Orca Exploration's share price is extremely depressed, well below its $11 per share reserve value. Orca trades well below that value for a host of reasons. While the company is at record production levels, its expansion plans are way behind schedule. TANESCO, the national power utility, owes Orca and other suppliers significant arrears, though about half has been repaid in the last several weeks after the government's receipt of $700 million of funding. And the amendment of the company's Production Sharing Agreement is overdue to be finalized.

Orca has significant net cash balances, record production levels, long-life natural gas reserves, operates at low costs with high netbacks and its gas remains in high demand as the company's gas production generates over 50% of the power in Tanzania. 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 within the next couple of years, especially since a pipeline allowing Orca's production to rise materially is finally being built by Chinese backers.

Our valuation for Orca is more than $8 per share or over 3 times its share price. The long awaited pipeline in the country is now being built. Once the company finalizes its Production Sharing Agreement and receives the balance of the monies owed by the national utility, Orca's price should rise to be more reflective of fair value.

Dynacor mills gold for other miners in Peru and its milling business does not really fluctuate much with the price of gold. The company just reported and its margins were relatively stable even though gold prices were down sharply in the quarter. The shares trade for just over 6x trailing earnings. We expect the company to be running a second larger mill by the end of 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. The first results from Dynacor's own gold mining operations have been excellent and we hope even more value can be added exploring its own properties over time.

Corridor Resources' shares have hopefully finally bottomed. Natural gas prices have rebounded and Corridor now expects to receive a premium of about $2.80 per mcf over prevailing prices from the undersupplied New England market. Corridor's Frederick Brook shale field should attract a partner soon. With over 1,000 metres of depth it's amongst the thickest gas shales in North America. Much discussed LNG export facilities in New Brunswick and/or Nova Scotia would, no doubt, benefit.

We also anticipate a partner for the company's Anticosti Island, Quebec shale oil project soon. On Anticosti Island, 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, should be closer to achieving a partner too. We expect the completion later this year of the ongoing Federal environmental assessment and both Quebec and Newfoundland appear accepting of the project.

At the current share price we are essentially getting all of the aforementioned mega-projects free because the value of the McCully field and its infrastructure alone are likely worth more than double the share price. Though Corridor still needs partners to initiate its projects, the company generates cash flow and has sufficient working capital while waiting for potential partners.

Our top holdings in our all cap portfolios include large cap positions, *Goldcorp, BMW* and *Arrow Electronics,* which are all discussed below in our Global Insight portfolio review.

Legacy Oil + Gas is a light-oil focused intermediate producer with assets in Alberta, Saskatchewan and North Dakota. Almost all of Legacy's production is light oil. The company produces over 18,000 boe/d and drilled numerous wells last quarter with a 100% success rate. There appear to be no operational concerns. Though the company's leverage is higher than we'd prefer, it should be at normal levels over the next year. We continue to cite only its lowered growth rate and the general malaise surrounding Canadian commodity producers to explain its underperforming share price, though the disconnect appears severe as the shares trade at more than a 40% discount to our FMV estimate for this company which has an enterprise value over $1 billion, and a 15-year reserve life, one of the highest in the industry.

Legacy's current value is 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 FMV estimate rises to over $18 in 3 years—about 3 times today's share price, a potential return of more than 40% per year.

Portfolio Changes

In the last few months we parted with Kohl's Corp., Jabil Circuit, ThyssenKrupp, MetLife and AIG after each of these large cap positions ran up to a TRAC™ ceiling, close to our internal valuations. Och-Ziff was sold too as it reached a ceiling in our TRAC™ work though we were able to repurchase it in June after it fell back to a floor in our work.

After selling part of our *Southern Pacific* position in Q1, when its share price gave us a TRAC™ sell signal and we believed the market was concerned with the delayed ramp-up of production, we repurchased more in Q2 after the price had declined. The company is just starting to ramp production of oil from its new McKay oil sands SAGD project. Volumes have been building very slowly but we now expect a faster lift from the use of higher pressure steam methods. McKay should reach its design capacity of 12,000 bbl/d within the next 12 months. The company trades at a severe discount to our FMV which should narrow with evidence of its production rise. The market is concerned with the small cash burn and the debt load. But we expect the company to be cash positive in the next few months and we are emboldened by the magnitude of the *proven* reserves, over $1 billion or $1.40 net per share—more than 3 times the share price.

We also bought *Qualcomm, Vivendi* and *Samsung* (all detailed in our Global Insight Large Cap section below) which, at the time of purchase, like most of our other large cap holdings, had potential returns in excess of 25% per year over the next 2 years assuming they recover to our estimates 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.

Global Insight (Large Cap) Portfolios – Key Holdings

Our Global Insight Long/Short Model (our entirely large cap model), is up 19.1% (USD) and 22.0% (CAD) in the 12 months ended July 31, 2013. A complete description of the Global Insight Model is available on our website.

We recently added to our *Goldcorp* position when we believed gold bullion was finally bottoming. Goldcorp is a likely rebound candidate given its position as the lowest-cost senior gold producer (all-in sustaining cash costs of below $1,100 per ounce) with the highest production growth rate over the next 5 years (approximately 70% from 2.4 million ounces in 2012 to over 4 million ounces by 2017) and a clean balance sheet. Assuming a recovery in the gold price to $1,450 per ounce (below the current marginal cost of production for the industry), the company was trading at a significant discount to our estimate of FMV at the time of purchase.

Apple, *Qualcomm* and *Samsung*: Often entire sectors or industries become undervalued for a variety of reasons. It is not uncommon for us to own more than one security in the same sector (e.g., AIG and MetLife until recently). Currently several companies tied to tablets and smartphones have become attractive over fears of decelerating growth and margin pressure. To be sure, smartphone growth is decelerating, especially at the high end, but we believe investors are missing the big picture, that global smartphone adoption is going to continue for many years. This has given us the opportunity to purchase Qualcomm, Jabil (recently sold), Apple for a second time, and now Samsung too.

In the case of Apple and Samsung, investor fears have gotten to a point where the growth assumption currently embedded in their share prices is now negative. In other words, the market believes that these companies are incapable of ever growing their earnings, which we find hard to believe. In Apple's case, we expect a cheaper iPhone model, a new deal with China Mobile (the world's largest carrier), a refresh of its iPad lineup and an accelerated share buyback program to keep earnings per share expanding. Trading at just approximately 12x next year's earnings (8x ex-cash) or a 25% discount to our FMV, Apple shares do not reflect any optimism about these new initiatives or any announcement of entirely new products such as Apple TV or wearable devices (e.g., watches or glasses).

Samsung currently trades at only 6.5x next year's earnings estimates. As with Apple, investors are currently focused on decelerating growth of its high end smartphone and declining margins. However, looking longer term, we expect Samsung's broad smartphone lineup to continue to experience strong demand. Beyond its handset business (which accounts for 60% of operating profit), we expect its semiconductor, display panel and consumer electronics divisions to enjoy a renewed focus on semiconductor profitability, value-added TV sales and continued adoption of NAND technology. A wild card for Samsung could be an

Apple-like buy back announcement. Our valuation work, which assumes very little growth going forward, implies fair value at more than 30% above the current share price.

Qualcomm has been caught up in smartphone growth concerns as its Snapdragon platform powers many high end mobile devices including the Samsung Galaxy S4, Sony Xperia Z, HTC One, and Nexus 5. Continued smartphone adoption, its competitive advantage in LTE technology and new market opportunities have Qualcomm's management confident it can grow its revenue at a double-digit rate over the next 5 years. Our FMV is 15% above today's share price.

We recently repurchased *BMW* for the Global Insight after it fell to a TRAC™ floor too. BMW shares trade at 9x estimated 2014 earnings, near the low-end of its historical P/E, despite achieving a near-record return on equity. BMW should benefit as the Eurozone continues to emerge from a prolonged recession. New products such as the X5, i3, BMW 4 Series Coupe, and Rolls-Royce Wraith are on the horizon. The share price has risen to within 10% of our sum-of-the-parts valuation, and we intend to sell down when it approaches our target.

Other tech companies we own are *EMC* and *Arrow Electronics.* EMC is a provider of enterprise storage systems and server virtualization software. Its shares rallied significantly after reporting better than expected Q2 earnings, though the shares still trade at a 15% discount to our $30 FMV. Arrow, one of the world's largest distributors of electronics/computer components, also rallied after reporting its Q2 results. It now trades very close to our estimate of FMV so we anticipate the position will be sold in the near future.

Just outside of the top five Canadian Banks, sits *National Bank*, trading at a lower price than we believe is warranted by the fundamentals. Although 65% of the bank's revenue is generated in Quebec, the market seems to be ignoring solid growth from the wealth management division, good revenue growth from the capital markets division and stabilization of the bank's net interest margin. Given that the bank generates an above average return on equity yet trades below the average price to book multiple of the "Big Five", we believe that there is room for the stock to continue to appreciate toward our FMV—nearly 20% above the share price—and narrow the valuation gap relative to its peers.

Telecom and media conglomerate *Vivendi's* road to realizing its sum-of-parts began with a key executive change over a year ago but only recently have we witnessed asset monetization. Vivendi has announced divestitures of Activision and Maroc Telecom which together accounted for about 65% of the company's consolidated cash flow. We suspect just about half of the proceeds will be used for debt retirement while the remainder will be earmarked for share repurchases rather than asset purchases. With another unsolicited offer recently rebuffed, we have confidence the total asset value to equity holders is 20-25 Euros which represents a potential 25%-50% upside.

Intact Financial is the largest property and casualty insurer in Canada with $7 billion in direct premiums written and a 17% market share, the number one market share in B.C., Alberta, Ontario, Quebec and Nova Scotia, operating under several leading brands. As the market leader, Intact's underwriting experience has consistently outperformed its peers and its 10-year average return on equity has as well. Severe flooding in Calgary and Toronto triggered a sell-off in the stock but with the impact of these adverse weather events now quantified, it appeared to have been an opportunity to build a position below our FMV.

The fierce selloff in the price of gold bullion allowed us to find beaten down gold producers with low all-in sustaining cash costs and clean balance sheets. In addition to adding to our Goldcorp stake, and buying Newmont too, we initiated a position in *Randgold Resources*, a West African gold producer. The company produced 800,000 ounces in 2012 and is looking to grow production to 1.5 million ounces by 2017, with all-in sustaining cash costs of $1,100 per ounce. Importantly, Randgold's reserves have been calculated at $1,000 per ounce and therefore management has not been forced to write down any of its projects in response to lower gold prices, unlike other higher-cost producers.

In the last few months a number of positions were sold as they approached our FMV estimates including: Devon Energy, Volkswagen, Cardinal Health (though we bought it again when it fell back to a discount), Nvidia, Prudential Financial, Suncor, Apollo Group, Kohl's, ThyssenKrupp, Archer Daniels Midland, MetLife and AIG.

A few fell below TRAC™ floors and we sold to avoid potential declines from those levels: American Barrick (which we replaced with Randgold), Freeport-McMoran, Newfield Exploration, Western Refining, Peabody Energy, Newmont Mining (though we bought it back lower), Rio Tinto, IBM, Netgear and Teva Pharmaceutical.

Other new additions in the period included *Aeropostale*, *Abercrombie & Fitch*, *CST Brands*, *Valero*, *HollyFrontier*, *Deere & Co.*, *Devry*, *Intel*, *Joy Global*, *Autodesk*, *Agrium* and *Dean Foods*—all at floors and at least 20% below our FMVs.

Income Holdings

As noted above, rates have jumped materially just since last quarter with 10-year treasuries now over 2.8% versus 2% last quarter. High-yield corporate bonds went from a record low around 5% to yield now about 6.4%.

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 for our income accounts are lower as we are carrying some cash to replace other bonds that have matured or that we have sold. In the current low-yield environment it's not easy to find attractive income holdings with favourable risk/reward relationships. We continue to screen 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).

Of note, regarding our top income holdings: *Specialty Foods Warrants*, a private company held only in our taxable income accounts, has increased in value (see the reference under All Cap holdings above); *Advantex's* business may change with the new Aeroplan arrangement but our positions are secured by receivables; *Pitney Bowes* preferreds have risen after significant asset sales; *J.C. Penney* bonds have slipped somewhat after a weak quarterly report and board infighting; *Student Transportation* school bus business continues to produce steady profits; *Brookfield Real Estate Services* keeps collecting its royalties which are steady because they are based more on the number of real estate agents rather than Canadian real estate prices or sales levels; *Thompson Creek*'s massive B.C. gold mine is nearing completion after spending $1.4 billion and a ramp up of gold production is expected throughout 2014; *League*'s bonds are set to mature next March.

Our cash position allowed us to take advantage of the intra-quarter volatility by initiating positions in three new securities:

- *Western Energy 7.875% January 30, 2016/19* (callable at the earlier date) notes were purchased at an attractive yield (6.8% yield-to-maturity) relative to the company's leverage and asset coverage. Even though the company's Canadian division is running at the best utilization rates in the sector, the company's cash flows are somewhat masked currently due to weather issues which have lowered overall utilization rates and by recent integration costs. With normal weather, a material increase in EBITDA in 2014 should raise the bond price.
- Exposed to a similar end market and offering a similar yield we bought notes of the larger, more geographically diversified oil service company *Calfrac Holdings 7.50% December 1, 2015/20*. At just above par value we viewed the 7.2% yield as attractive and outsized relative to the company's leverage ratio and asset coverage.
- The operator of over 700 casual dining locations, *Ruby Tuesday 7.625% May 15, 2016/20* notes were also initiated near par yielding 7.8%. The company continues to sell (and leaseback) its restaurants' real estate, while at the same time producing significant cash flows with very limited reinvestment opportunities. We anticipate total debt outstanding to decline from constant restaurant cash flows which should help lower the yield and increase the price of our notes.

We exited Pinetree Capital debentures and averaged down in the following: *Southern Pacific* convertible debentures, as the price went well below what we believed was reasonable given the substantial common equity value we ascribe to the company from its reserve values and corporate progress albeit 6 months delayed—asset coverage is still over $1 billion of proven reserves against $430 million in total corporate debt; *Renegade Petroleum* common shares after the company reduced its dividend to 8% and is looking at strategic alternatives; and *IBI Group* convertible debentures where the company eliminated its common dividend and the bond price declined too far in our view relative to the wherewithal for the company to meet this short-term (end of 2014) obligation.

Bottom Line

While we obviously prefer when our stocks recover faster and drive our performance higher, we are pleased with our returns over the last year, especially in light of falling commodity prices and the 22% decline in small cap Canada (the TSX Venture Exchange Index).

The disconnect between values and prices continues to be unusually wide and the underlying values for most of our holdings keep growing. Both should contribute to potential outsized returns going forward.

Along with the U.S. market, our large cap holdings have performed admirably. A number have surged to TRAC™ ceilings and/or close to our FMVs and therefore we traded them for other undervalued positions.

Clearly we are attentive to the macro, and it is important in our investment process. Strong economies mean higher demand for goods and services, better for growth of corporate earnings of equities. But that strength also means higher interest rates, bad for bond prices, competition for equities and their valuations.

The point is, if you can't ascertain the direction of economic growth, and if the markets as a whole are at relatively high valuations, you are compelled to seek out those individual undervalued opportunities that provide good potential returns. Our bottom up point of view.

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