TRAPEZE
ASSET MANAGEMENT

# THE LONELY HEARTS CLUB

Value investing means buying what's at bargain prices, usually from the unpopularity of those investments. And selling, and selling short, what's at overvalued prices usually from over-popularity and/or excessive expectations. Recall Nortel at a whopping $400 billion market cap in 2000, a market cap one-third of the entire TSX, and now bankrupt. Research In Motion at $150 per share in 2008, now $8.50 down 94%. Splunk, a popular software company (which we recently shorted) with a market cap that reached nearly $4.0 billion but with minimal earnings.

Herb says he feels most comfortable in an investment idea when he's lonely. That is, when nobody else cares. When it is out of favour. Lonely bargain hunters should be looking at distressed U.S. real estate, especially in places such as Florida and Arizona, or even Spanish real estate. In our universe, clearly small cap stocks, natural gas producers, cheap gold producers especially relative to the gold bullion they produce, and underearning insurance companies stand out. Contrarian ideas to be embraced by the lonely few. At the other end of the spectrum, mainly from fear of stocks, the overpopularity of bonds yielding next to nothing, and likely a short. Fear often breeds irrationality. Which can create opportunity for those lonely souls with foresight and, importantly, with patience.

It's the popularity or unpopularity that creates the "wrong" price, the "inefficiency". We often go against the grain—whether buying or shorting, to the chagrin of many of our clients, to whom "contrarianism" is often misunderstood. Sometimes the consensus is right. But often it is best to be contrary, to find the inefficiencies, especially for the longer term, and especially at valuation extremes, whether undervalued for purchases or overvalued for short sales.

Value investors want to buy low and sell high. Or as fellow investor Tony Gray puts it, "buy cheap and sell expensive." "Momentum" investors prefer to buy high and sell higher. The distinctions are religious. You either get the philosophy or you don't. Most get it at the grocery store or when buying a house, but can't seem to apply it to the market, perhaps because there's a general belief that prevailing market prices accurately reflect value.

**Patience Rewarded**

The 2008 Panic, and then 2011, were unhappy experiences for us even as dyed-in-the-wool value investors, stemming from the unusual illiquidity and volatility of our cheap small caps and, in some cases, their inability to finance themselves in that earlier environment. From those very characteristics small caps have generally become unpopular, actually shunned, with most trading at much lower multiples of cash flow and earnings than their larger cap brethren, but likely, ultimately, with bigger upside potential.

The current market is extremely bifurcated, as fear and pessimism have created an unusually big gap between the returns from bonds and stocks, between the most overvalued stocks and the most undervalued, and between the big cap popular stocks and the much more undervalued mid and small-cap stocks. A recent article in Barron's noted the observation by Brandes Investment Partners that "Today, the cheap end of the stock market looks even more inviting than usual. Based on the ratio of stock prices to company book values, the priciest 10% of the market was recently 14.5 times as expensive as the cheapest 10%, versus an average since 1968 of 12.3 times. In the past, when the spread between pricey stocks and cheap ones has been wide it has tended to be an excellent time to buy the latter."

As for the current popularity of bonds over stocks, over the past 80 years investors in bonds have earned an average of only just over 2% a year, adjusted for inflation. Currently, equity investors are getting an S&P earnings yield of 8.0% and a dividend yield of 2.3%, compared to a paltry 10-year treasury yield of 1.6% (before inflation).

As to the great disparity between stock groups, many pros on Wall Street and Bay Street recognize it (and are frustrated by it), but the public generally doesn't. And many of those pros who are investment dealers are struggling to get financing for those smaller companies. But the mid and small-cap stocks we own are cheap, with good balance sheets and firing on all cylinders. We believe, ultimately, the extremely unjustified disparity will shrink and the laggards will outperform. How long will it take is the question. But value—and patience—will out.

Herb likes to remind that all large caps were once small caps. And probably remembers dinosaurs too. He recalls that Barrick Gold, now the world's largest gold producer, was a penny stock in the mid 1980s. Microsoft, now at $27, traded at $1.00 in 1990, Oracle now $30 was $0.78 in 1993. Patience was clearly rewarded, certainly for Peter Munk, Bill Gates and Larry Ellison.

Smaller cap companies are, and need to be, cheaper with greater upside potential, often being more volatile because they are less liquid. But we also hold and see attractive large caps to add, which, unlike the smaller caps, tend to move in and out of favour more rapidly and also offer good rates of return.

**Helicopters And Parachutes**

Ben Bernanke, Chairman of the U.S. Fed, said he would drop money from helicopters if need be to help the economy. So we now have QE3, ultra-low U.S. treasury bond rates and the Fed buying $40 billion of mortgage-backed-securities monthly. And the expressed intention of keeping rates low for a considerable time after the economy recovers. A serious parachute for equity investors. And with earnings growth appearing to have slowed and companies needing to grow sales, the Fed stimulus and improving confidence should help. Remember the adage, "Don't fight the Fed."

Consumer confidence in October did improve, to a 5-year high. Retail and restaurant sales also improved in September as confidence encouraged spending. Personal incomes and spending were up in September too. Durable goods orders were up 9.9% in September. As a result, Q3 GDP grew at a slightly better annual rate of 2%. Housing is improving too, August existing home sales up 7.8% vs. 2.3% in July, and housing starts up 15% in September to a

4-year high. Building permits too, up 11.6%. And new home sales in September jumped to their highest level in 2 years. All understandably, with housing so affordable, with home prices starting to rise from the diminished number of homes for sale (the median existing house price up 9.5% from last year and the new house price up 11.5%) and with banks, craving yield, encouraged to lend on mortgages. Indeed, the better mortgage business is helping mortgage lenders generate lending fees to offset the effects of low interest rates. Even as housing obviously improves we are short a Homebuilder ETF inasmuch as it met the "overpopularity" test and got very extended to the upside.

Auto sales are continuing strong too, now at a 14.9 million unit annual rate. And, at over 10 years, the age of the fleet suggests more demand to come, augmented by the damage from Hurricane Sandy.

American manufacturing picked up in October and the ISM survey of purchasing managers in the U.S. rose to 51.7 in October showing expansion, with new orders and employment rising. And while German and Japanese exports are falling the U.S. reported a smaller trade deficit for September from better exports, which should help Q3 GDP. The U.S. unemployment rate in October was 7.9%, about the lowest level in nearly four years, with initial jobless claims falling and workers coming back into the workforce. Total debt to GDP is improving. Incomes are rising and consumers' debt relative to earnings has been improving too, wherewithal to spend as confidence continues to rise. Parachutes all.

And while the consumers' debt picture, though improving, may still be weak, corporate balance sheets on the other hand are outstanding—corporations are flush with cash, for expansion, buy backs and dividends.

But even as the U.S. economy is slowly on the mend (the impact of Hurricane Sandy still undeterminable), the global economy, though still growing at 3.3% in 2012, continues to weaken, especially in Europe and Asia. Europe is in a recession and the European Union has cut its growth forecasts, as unemployment remains high, consumers are struggling, export growth is sluggish and governments need to cut budgets. But foreign countries know about helicopters and parachutes too. Asian growth has slowed but there are signs of a pickup. China's foreign trade surplus widened in September with exports up 9.9% year over year and new orders and output at their highest in months. Nonetheless, now with reduced GDP growth of 7.4% in Q3 and moderating annual inflation in September to 1.9%, and better growth data in October, China is also expected to stimulate now that its recent election is over. India will too, even though it grew at a better than expected 5.5% in Q2. Japan, with its first current account deficit, is stimulating also, and South Korea, Brazil and Australia all recently cut interest rates. The Chinese, Shanghai and Hong Kong markets technically look to be bottoming. Europe, believe it or not, will hit bottom one day. The U.K. has recovered from its recession with Q3 GDP growth up 1%, the best in 5 years. The Euro currency holds up inexplicably well. Spain's economy contracted less than expected in Q3. And, believe it or not, depressed Spanish real estate is being gobbled up by deal seekers.

**Searching For Return**

Q3 has certainly been disappointing for corporate earnings, with downbeat forecasts, mainly attributable to the slow global economy, and it has led to the recent market correction. Maybe a bit more downside ahead until psychology becomes sufficiently negative.

But our econometric model, Trapeze Economic Composite (TEC™), shows no sign of an impending U.S. recession. Both monetary and valuation conditions continue to be favourable. 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 which in fact has occurred (TRAC™ and TRIM™ are described in detail on our website). The possibility of a rise in taxes on capital gains and dividends next year may be encouraging sales before the end of this year. Over the next few weeks we expect the previous overbought levels to be alleviated setting the stage for another prolonged rise. An opportunity for buying stocks that have pulled back.

With the markets overbought, we employed some defensive measures. First, we sold a few holdings as they hit our targets or gave TRAC™ sell signals. As well, in long/short accounts we added a few more short positions in stocks we believed were overvalued, which could serve as a partial hedge in any market decline. We shorted and covered Splunk recently, a company whose market cap rose dramatically since its April IPO to nearly $4 billion while its annual sales are less than $200 million and the company is barely profitable. The company has plenty of competition and about 50% of the shares were set to unlock as of October 15. Insiders already had sold considerable shares on a secondary issue at much lower prices in July. We remain short 2 restaurant stocks, a retailer, a real estate landholder and a Homebuilder ETF. Each of these are at, or inflecting down from, TRAC™ ceilings and are extended relative to our fair value estimates. We also bought short-dated S&P index puts (in accounts authorized for options trading) when the volatility index hit a low (making the puts relatively cheap), but we just sold them prior to expiry at a loss—the cost of insurance attempting to mitigate from a significant negative macro event.

**Confidence Improving**

John Aitkens, investment strategist at TD Securities, observes that consensus forecast is for accelerating growth over the next 6 quarters, with a trough in S&P 500 earnings momentum growth in Q3 (the current disappointing quarter being reported which has left investors cautious), but for rising earnings momentum in the year ahead, and a reacceleration of growth over the next two years with rising top-line and bottom-line momentum. And, we believe, that, as confidence continues to improve, and interest rates stay low, P/E ratios should expand, as investors, searching for return, will be willing to pay more for those improving earnings. Moving their holdings to riskier assets, to stocks from bonds and cash. From parachutes to hot air balloons.

Investors hate uncertainty. Now that the U.S. presidential election is over, one significant uncertainty is removed. And now the government will be forced to address another uncertainty, the "fiscal cliff" at year end—onerous tax increases and spending cuts totalling over $600 billion—to assure that the economy doesn't fall back into recession. A "grand bargain", bipartisan compromises, will clearly be required, probably with higher taxes for higher earners. Deficit reduction, stimulus, and economic recovery are in everyone's interest. Necessity is the mother of invention. And of compromise. Importantly too, the Fed's quantitative easing is assured, the reflation will continue, and that's good for equities. And confidence.

Ultimately, with investors focussed on economic recovery to lead, it may actually be the markets which lead the recovery. Bottom up may win. Rising equity markets and house prices, for greater confidence, spending and wealth creation.

**Our Cheap Stocks, Large And Small**

While our allocation to larger caps continues to increase, the smaller caps we still hold remain extremely cheap with higher potential upside. While everyone is running thin on patience after many years of waiting for smaller caps to revert back to reality, patience should ultimately be rewarded and be worth the wait. The TSX Venture Exchange Index, our proxy for Canadian commodity small caps, is still down more than 60% from its high of 5 years ago. This cannot last.

Though the smaller cap companies we hold clearly present greater risk in terms of their volatility and liquidity, because they trade well below our appraised values and because those values are rising, we forecast a move to our fair value estimates as their operations continue to improve and/or sentiment normalizes. Investors ought to recognize these values. Managements are as frustrated as we are and will likely be focussed on extraordinary mechanisms to make up the difference between price and value—normal course issuer bids, corporate buybacks, mergers and acquisitions, or even privatizations.

The disconnect for our companies that trade so far below our Fair Market Value (FMV) estimates is primarily attributable to their unpopularity. The market is either still fixated on the horrible '07/08 collapse of small companies' shares, concerned with past negative company-specific items and not willing to overlook them yet, or simply anxious about the global economy and, in particular, therefore not willing to hold less liquid small-cap stocks. Until recently, for smaller cap stocks, even positive results had been mostly ignored.

However, our holdings are adding to underlying values through their operations and their values will be difficult to ignore as their FMVs continue growing. Most of our holdings already trade at a fraction of our estimated appraised values. So we should benefit from the rise in underlying value and as their mispricing is corrected along with the rise in share prices, over time, to more fully reflect underlying value.

And while we think stocks generally are reasonably valued relative to current low interest rates, as contrarian value investors certain sectors really stand out. Energy stocks, for example, where we are concentrated. We think oil prices should hold at current levels (we use $85 WTI prices in our valuations) and, after the current correction, should head higher. We also believe natural gas prices have seen their bottom and, indeed, they have risen from $1.90 per mcf to the current January price of about $3.75 per mcf, from greater competitiveness with coal for power—so higher consumption—significantly reduced drilling rigs for gas—so lower production. At, say, $4.50-$5.00 per mcf, a likely price if we have a normal winter, natural gas companies should be able to ramp up production and generate much better cash flow.

**Our Top Holdings—Beautiful Wallflowers**

***Manitok Energy*'*s*** share price has run up to all-time highs, though our estimate of underlying value also keeps rising from the growth in the company's production, reserves and net asset value. It is now producing over 3,500 boe/d and should be at a run rate of over $50 million of annualized cash flow by year end, on nearly 4,000 boe/d of production. Value then should be about $4 per share, rising much further in the next 12 to 18 months as the production and cash flow over that period is forecast to double.

Manitok is gaining in popularity. Daily volume has increased manifold. Several brokerage firms now recommend the shares. The company is now coming onto investors' radar screens and the larger it gets, the more screens it will appear on.

So far Manitok's experienced team and prolific properties have contributed to 100% drilling success. And some of the wells have been beyond expectations. In fact, 2 of the wells drilled have been amongst the best drilled in Alberta in 25 years. Most have free flowed oil to surface (i.e., without fracing), a testament to the quality of the reservoir.

But Manitok still remains mispriced. If it decided not to grow but merely drill 3 wells a year to subsist, Manitok's free cash flow (assuming $85 oil) would be about $35 million annually today. With an equity market cap of about $175 million, that's a 20% hypothetical free cash flow yield. Hypothetical, because we expect the company to use its cash to drill at least one well per month for the next few years which should continue to add materially to the underlying value. In just 3 years' time, Manitok should have annual cash flow (assuming $85 oil) in excess of $1.80 per share. And at 4-6x that cash flow (where its peers typically trade) we believe the share price should then be 3-4 times today's level.

The main risk for Manitok is oil prices. However, as is our opinion for gold, we forecast higher prices over the next few years. Low real interest rates, higher costs of production, and rising global demand are expected to keep both commodities strong.

***St Andrew Goldfields*** hit another record with 25,700 ounces produced in Q3 '12 and is on track to produce about 95,000 ounces in 2012. It just reported Q3 earnings of $0.02 per share and $0.04 per share of operating cash flow. At prevailing gold prices, operating cash flow should be about $0.17 per share for 2013 as production continues to grow. At less than 3x next year's cash flow, with about 10% of the market cap represented by net cash, and trading at a lower Net Asset Value and cash flow multiple than its peer group, nobody would declare grossly undervalued St Andrew the winner of any popularity contest.

The company's share price has recovered 50% from its 52-week low. However, just as it was gaining favour over the last number of months, the company recently announced an error in its last year's inferred resource calculation. Importantly, the minor revision did not affect reserves or measured and indicated resources, or the net asset value, as the resource continues to grow. It did though temporarily impact investors' confidence, restraining the share price.

Our 3-year target remains at over 3 times the current share price (at an 8x cash flow multiple and assuming lower gold prices than currently). Based on our production estimates, the company should have about $135 million of cash (or nearly 75% of its current market cap) in 3 years, plus it would then be earning free cash flow of about $0.13 per share. The continued expansion of the resource, ramp up in production, decline in costs and healthy gold price should help keep St Andrew's bottom line and cash generation at record levels. We believe that the share price will continue to rise and reflect the underlying increase in corporate value.

***Specialty Foods***, a 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. Half of our remaining debentures will be repaid next June and the balance one year later, but we retain all of our warrants. Specialty Foods is having a record year in 2012 as volumes are 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 annual free cash flow we expect Specialty to generate over the next couple of years (until the existing manufacturing/distribution contract with Nathan's expires), we estimate that the total value of the bonds and warrants should be double our current total (debentures plus warrants, with all the potential value coming from upside in the warrants) carrying value. The company would likely liquidate its remaining assets after the contract expires (the existing contract expires in March of 2014). On the other hand, if Specialty is able to establish a new multi-year contract with Nathan's, the value of the debentures/warrants will be substantially higher—much more than the double a liquidation could bring.

***Orca Exploration*** also is running at record pace after reporting its latest quarter. The company 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. The company's gas production generates over 50% of power in the country.

You wouldn't think such a strategic asset would be at the bottom of the popularity totem pole. But Orca trades at a 75% discount to its reserve based net asset value because of the perceived political risks and illiquidity of its shares. Since late last year the company has had to deal with various issues from government bodies in Tanzania. Meanwhile, the government signed an agreement with a Chinese sponsored group to build a major pipeline which has started construction, and major oil companies have made massive gas discoveries nearby which has spurred government plans to better support gas-fired power generation. The new pipeline should allow a ramp-up of Orca's production and cash flow once completed in late '13 or early '14. The share price still hasn't recovered from allegations made by low level parliamentary members even though those officials have been removed from the government under the suspicion of corruption. TANESCO, the national power utility, is current again on its obligations to Orca, though it still owes significant arrears, anticipated to be received shortly. And, the spectre of any material revisions to Orca's production sharing agreement has dissipated.

Orca's current reserves are valued at over $8 per share—nearly 4 times its share price. The company has temporarily deferred exploration drilling of Songo Songo West until its funding position is clearer, meaning the government is in a better situation to pay its bills. And, the miss of its first well in Italy, though not part of the reserve value, didn't help it gain any favour.

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.

**Legacy Oil + Gas** keeps hitting the ball out of the park. The company continues to report record production, higher cash flow and industry-leading netbacks while reducing operating costs. Most importantly, it continues to bat "a thousand"—it drilled 46 wells last quarter with a 100% success rate. Subsequent to the company's third quarter earnings report, Legacy released an updated resource assessment to highlight the exceptional potential contained within the company's asset base. In addition to Legacy's 88.0 million barrels of proven and probable reserves, the latest resource assessment indicated an additional 82.6 million barrels of best-case contingent oil resources. Essentially, the report suggested that Legacy's lands contained over 2,000 net development locations, some of which would be amenable to waterflooding which would enhance the ultimate recovery rates.

Despite the excellent operating results, at $7, Legacy trades at about 60% of its net asset value. Its lack of popularity is a bit mystifying. We struggle to find any rationale for its undervaluation. Remember, this is a company that produces mostly light-oil in Alberta, Saskatchewan and North Dakota so perhaps it's simply a concern for the risk that lower oil prices may ensue. However, we estimate that Legacy could continue to grow by over 25% per year at current oil prices as it exploits its ample asset base. Further, the company has recently pointed out that its business model is sustainable and self-funding, implying that a growth plus yield option remains feasible if the market won't pay up for production, cash flow and resource growth.

Taking advantage of recent market volatility, we sold about one-third of our position in reaction to a TRAC™ sell signal in early June at about $6.80 and repurchased shares in July at about $4.90 at a TRAC™ floor. Assuming $85 oil, we anticipate our FMV estimate may rise to over $18 per share in three years—a target which implies a nearly three-fold return from today's levels.

***Pivot Acquisition*** is a private IT outsourcing company in which we hold 12% convertible debentures in our taxable accounts. We received 22% in the first 12 months we owned Pivot, including the 12% coupon and 10% extra penalty interest for Pivot not having met its initial IPO timeline. And we received another 10% penalty, on top of the regular interest payment, 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 is still looking to create a liquidity event by going public, at which time our debentures convert to shares on highly favourable terms. We look forward to a significant lift in our carrying value.

The company's EBITDA this year should be about $50 million and it expects $60 million in 2013, without acquisitions. And there are many similar small IT companies for Pivot to potentially acquire to further add value.

***Dynacor*** is not only an outcast, but was actually recently a cast-off. We added to our position for most clients in June, buying the remainder of a sizeable position in a fire-sale from a hedge fund that went out of business last quarter, with a stink bid of $.37. The company just reported earnings of $.07 this quarter alone and the share price jumped to $1.20. Dynacor mills gold for gold miners in Peru. It has a stable business with margins that don't fluctuate dramatically, even with the price of gold. The company has the highest retention rate of millers in its region, and when the Peruvian government tightened its regulations, Dynacor was able to win business from other non-compliant competition. While the most recent quarter had higher than normal grades, from excellent throughput and the ability to accept higher quality business moving away from competition, we still expect at least $.05 per quarter of earnings. And, by the middle of next year, we expect the company to have built a second larger mill which should expand earnings power to well over $0.25 per share annually. While the stock price has risen dramatically since June, it is still too low.

There is unpopular and there is unknown. Dynacor has been off the radar screen. No analysts cover the company. It operates far afield, in Peru. Its earnings, previously insignificant, have now visibly ramped up to a sustainable meaningful level from production growth. September was a record month of production of 5,757 ounces (over 50% more than last year's Q3 run rate). The market has taken notice and we expect more to follow.

The company also has its own potential gold exploration property where it expects to begin drilling shortly, which could also add substantial value. Based on milling alone though, the company should have a value closer to $2.50 per share, double today's share price.

***OfficeMax***, although known to consumers and with sizeable sales, has been overlooked by investors because of the negative sentiment toward anything smaller cap and also perceived as being under threat from the Internet providers. Top-line growth for this $7 billion revenue company's 1,000 retail locations is dependent on small business formation, which has yet to occur. That said, the company is employing its own levers to advance earnings, including operating efficiencies and cost cutting. And it's working. The company just reported a stellar quarter with slightly lower top line but about a 40% profit lift.

The company's market cap is now about $700 million. Non-operating assets, on and off balance sheet items, are at least $180 million (potentially much more as one of their key assets is lifting materially in value along with the housing recovery), including net cash of $125 million. We are essentially paying just $520 million for the current free-cash-stream of $60 million annually, or about 8.5x free cash flow. Management's guidance is for $120 million of EBIT. During 'normal' employment and business formation years the company has earned 2.5-3% EBIT margins which translate into nearly $200 million using today's somewhat depressed revenue run-rate. As the share price rose quickly to within 15% of our FMV estimate we lightened up. Yet, there's still good potential upside to our 3-year target.

***MetLife***, like most insurance companies today, is out of favour because the prospect of higher interest rates from fixed income holdings, a key source of earnings, appears dim and the prospect of more government regulation appears likely. So this dominant international life insurance company trades at less than 6x earnings and well below book value. Our FMV estimate is over 50% higher than the share price, and growing. The company has excess capital which it and key shareholders would like returned to shareholders via dividends or share buybacks. However, the sale of its small banking operation, which is overseen by the Fed, has been holding up the process for months. While frustrating, this should be resolved shortly. 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.

***Corridor Resources*** may be the poster child for unpopularity. That's why Herb likes it more every day. Investors have given up on it. Understandably. Natural gas prices have been horribly depressed; environmental protestors have been urging, and governments have been studying, shale gas fracing for a possible moratorium; Old Harry in the Gulf of St. Lawrence is the subject of a Federal environmental study and in somewhat of a political stalemate, while Quebec is stopping shale gas drilling altogether which could impact its Anticosti shale oil prospects. Yet, the company is subsisting, generating a little cash flow as was just reported.

But reality is often different than perception. Gas prices have been recovering; less capital allocated to gas projects with gas drilling rigs in the U.S. collapsing by about 70% since the '07 highs; significant switching from oil and coal to natural gas; various initiatives to use natural gas for transportation and plans to construct LNG facilities to export gas to foreign markets where gas prices are much higher. While this will take time, the writing is on the wall, but as the economist Jim Lymburner used to say to Herb, "Not everybody can read it."

The company continues to seek partners for its 3 mega projects. The Frederick Brook shale gas field, with 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 1,000 metres of depth, could come to life sooner—if the Repsol LNG import facility (now for sale) in New Brunswick is acquired and reversed. Regarding Corridor's shale oil project on Anticosti Island, Quebec, with 19.8 billion barrels of oil equivalent resources in place, our understanding is that Quebec may be allowing shale oil fracing, but does allow for testing.

And, at the highest levels in government, the Old Harry project in the Gulf of St. Lawrence with a potential 2 billion barrels of recoverable oil, was recently discussed by Prime Minister Harper and the Quebec Premier, with a view to moving it forward. The stalemate there will hopefully end coincidentally with a positive Federal environmental study, allowing for drilling on both the Newfoundland (60%) and Quebec (40%) portions of Old Harry.

Any of these projects has the potential to provide material upside for Corridor's share price, and the company's reserves, infrastructure and land value alone are worth significantly more than its current market capitalization. Corridor is debt free and can await a resolution of these issues. While the timeline is still uncertain because the company is seeking partners, we believe the longer term risk-reward ratio remains extremely favourable. And higher natural gas prices, which we believe are inevitable, would clearly enhance its value by providing higher cash flow and the accelerated development of even its conventional gas assets.

**Additions And Deletions**

We have added shares of *Southwest Airlines, AIG, and Owens-Illinois*. Each is a leader in its field, highly profitable with competitive advantages, and trades well below our estimate of FMV. All three suffered from temporary overhangs of pessimism relating to, in the case of Southwest, high jet fuel prices and an anemic economy; for AIG, the potential for additional government regulation and further sales of the government's stake (though it's mostly been eliminated already); and for Owens-Illinois, its overly aggressive growth plans to meet incremental demand causing self-inflicted bloated costs as it had to ship its glass products from plants farther from customers.

As a few of our holdings rose to ceilings closer to Fair Value we sold them, including Oracle, Google and Och Ziff. And after reducing each in Q2, we recently parted entirely with the remainder of our Dell and Fortress Paper. Dell on a TRAC™ sell signal and Fortress Paper, after poor earnings and the fact that the company was having to sell its dissolving pulp to certain customers below its hedges. We will monitor all for reinvestment as prices and events unfold.

We continue to analyze a host of primarily large companies and review the most undervalued stocks in our universe of about 1,000 global large-cap companies screening for those that meet our hurdle rate of a potential annualized 25% 2-year return, while still seeking out the special situation small-to-mid-cap opportunities.

**Income Holdings**

Though less liquid than government or investment grade corporate bonds, our income holdings are either higher-yielding corporate bonds where we believe the risk/return is favourable, often with potential for capital appreciation, or REITs and 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 return 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, income portfolios could 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: *Advantex's* profits continue to grow as it expands its merchant base; *Radio Shack's* bonds, due next August, are well covered by the cash hoard on its balance sheet; *Southern Pacific's* convertible debentures are even more attractive now that its new project is underway and delivering; *Pivot Acquisition*, mentioned above, is growing its profits smartly and working towards a liquidity event; *Smith & Wesson* bonds have jumped in value with the rise in the company's profits; *Specialty Foods*, as mentioned above, continues to deliver, with the warrants providing material potential upside; *Pinetree Capital* debentures have rebounded now that smaller cap stocks, which it holds, have stopped declining; *Student Transportation* continues to deliver consistent earnings growth; *NII Cap Corp's* bonds have been more volatile but rebounded recently as analysts talk up the replacement value of its assets.

We had 2 recent additions in our income accounts. We added *Brigus Gold* 6.5% convertible debentures. The 9.7% yield-to-maturity (2016) appears mispriced relative to the considerable 6x asset and interest coverage for this Timmins, Ontario based gold producer. We anticipate price appreciation in the coming quarters as the company begins to produce gold in line with its guidance. And we bought *Pitney Bowes* 6.125% preferred shares with a yield-to-call of 8.9%. These preferreds were written with extremely favourable terms to the creditor. Though the preferred is perpetual we fully expect the company to redeem them at the 2016 call date as the coupon compounds 50% on each coupon date thereafter. The parent company continues to effectively manage the ongoing cyclical and secular challenges facing mail services—since 2007 the company has generated between $650 million and $830 million of annual free cash flow and has recently provided 2012 guidance of $750-$850 million free cash flow.

**Worth The Wait**

We really, really like our current portfolios. Our companies are not only cheap, with good balance sheets, but their businesses are doing very well, with excellent future prospects. While not as cheap as our small caps, our large cap holdings are cheap and attractive too, and have the important added advantage of helping us to trade them whenever they get extended, using our TRAC™ work to reduce or eliminate holdings when they are overbought at a "ceiling" and to buy or add to them when they fall to a "floor".

Value investors need to be patient and stay the course. It's indeed frustrating to wait until what's undervalued is discovered and generally embraced. Renowned investor, professor Joel Greenblatt, said in a recent interview regarding his "Magic Formula", "So the magic formula, like all value investing, can give you noisy returns over the short term, but that's also why it continues to work." But staying lonely and avoiding crowds usually pays off over the longer run. Worth the wait.

Until more people want to join the Lonely Hearts Club.

Herbert Abramson and
Randall Abramson, CFA
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