TURNING OVER ROCKS

The S&P 500 is at a record high and we believe the markets generally are fully valued. Corporate revenue growth is anemic, profit margins are stretched, and the prospect of earnings rising meaningfully is not high. And, the outlook for the U.S. and global economy is still uncertain. Market psychology is at a level suggesting the market is overbought. Margin debt is at record levels and the current popularity of stocks by retail investors at market highs is in itself a red flag. The equity markets have benefited from the huge inflows from low-yielding bond funds into U.S. equity funds. We don't believe that a bear market is looming, merely that a healthy, overdue correction could be near. And that, from current levels, the upside is likely to be below average, particularly because the S&P 500 is already 7% above our Fair Value estimate. The U.S. indexes are also 30% above our TRIM™ lines, as stretched as they ever get, and at TRAC™ ceilings.

As value investors, we are finding we need to turn over more rocks to find those value opportunities that meet with our risk-reward parameters. We have previously pointed out, one of the most overvalued groups is the so-called defensive consumer staples, today's apparent proxy for bonds. Conversely, the most undervalued are the cyclicals, materials, energy and commodity stocks generally. Axiomatically, outperformers tend to be more fully valued or overvalued than underperformers. Value is usually found in what is unpopular. Benjamin Graham, the father of value investing (Herb thinks he is) said, in the short term the market behaves like a voting machine, but in the long term it acts like a weighing machine. Witness Splunk, Lifelock, Facebook and, recently, Twitter, at about 25 times projected 2014 sales—exuberant voting.

Interestingly, new share offerings soared over $15 billion in one week recently, the highest volume this year, while corporate buy-backs have slowed to the lowest since '09. And, unprofitable stocks recently represented over 60% of IPOs, the highest level since 2000. The number of bullish investment advisors compared to those bearish is over 3, another indication of excessive voting machine sentiment. Indiscriminate and overly exuberant buying means investors are skipping over the rocks, not looking under them. Shades of the 2000 bubble? Only about 15% of our 1,000 company global large-cap universe trades for less than $0.80 on-the-dollar according to our valuation model (TVM™). A level typical of market tops. As consummate value investors we are wary of the voting machine which makes the markets overvalued, and we are waiting patiently on the weighing machine we always embrace.

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Understandably, in this market euphoria, hedge funds, hurt by their shorts, have significantly underperformed their long-only counterparts, and our hedging activities (albeit relatively small) have also hindered our performance. Many have even launched long-only versions of their hedge funds (i.e., without hedges). But, as we attempt to protect against the downside, we believe shorting will prove to be worthwhile and we will be rewarded.

Oh, Canada

The Canadian markets have significantly underperformed their U.S. counterparts. The TSX is up 10% (CAD) in the last 12 months compared to 31% (USD) for the S&P 500 and 32% for the NASDAQ. Interestingly even the U.S. small cap Russell 2000 is up about 39% over the same period. We attribute Canadian market underperformance to the fact the TSX is populated with more basic materials companies. Gold and silver stocks have been a disaster. Canadian junior companies have been in a bear market, the TSX Venture Exchange, the proxy for small cap Canada, down 22% (CAD) in the last 12 months and down 73% from its '07 high. Recently, however, it has bounced off a floor in our TRAC™ work and has started rising again.

Our Canadian small cap names have obviously suffered too, and impacted our performance, notwithstanding that our larger cap names have performed very well.

Though we want to continue to hold cheap small caps because we expect them to significantly outperform going forward, we are focussing more on undervalued larger cap names. Looking under boulders, not rocks, or should we say, pebbles. And we look internationally, not just in the U.S. or Canada. We screen some 1,000 large cap names globally, and hope by looking carefully under rocks we can start to outperform. We want to be rock stars again.

Rock Skeptics

We also want to look carefully, and skeptically, under the rocks of recent economic and market data. The S&P 500 is at a high. So too are corporate margins. Sales increases have been less than robust and costs should ultimately start rising, particularly from higher labour costs. Going forward, earnings growth may be stalled. U.S. cyclical stocks have had negative growth for three of the last five quarters. Corporate insiders are wary too, as evidenced by rising insider selling.

While the U.S. October payroll report was better than expected, the unemployment rate rose slightly to 7.3%. And the labor force participation rate dropped to its lowest since 1978, private sector hiring actually declining, and average hourly earnings rising only marginally. Although housing prices have strengthened, with rents also inflating from an undersupply of rentals, paradoxically, September and October saw a decline in pending home sales, the lowest since December, likely from the higher mortgage rates and prices. Housing starts have also been low, back to the '50s level, so there is not a lot of supply. But building permits climbed in October to the highest in 5 years, so housing should contribute to growth.

Consumer sentiment also worsened in October and November to its weakest in ten months, no doubt affected by the Federal shutdown which in turn influenced the consumer's outlook for the economy. And many large retailers, such as the largest, Wal-Mart, are reporting disappointing earnings.

On the other hand, U.S. and Canadian manufacturing expanded in October at the fastest pace in nearly 3 years. Indeed, October was the fifth month in a row of faster manufacturing growth, which seems also to have picked up around the world, China and other Asian manufacturers showing the quickest upturn in months.

Economic Dichotomies

Despite the improved manufacturing numbers, world economic growth remains sluggish. U.S. and global retail sales volumes are growing very slowly. While reported U.S. GDP for Q3 was 2.8% annualized, without the large buildup of business and farm inventories from lower consumer spending, it was likely only 2%. And, U.S. consumer sentiment for November is near a 2-year low.

At the same time, the Eurozone has lowered its growth forecast with unemployment still at a very high 12.2%, and anemic Q3 GDP growth of only 0.1%, including slower growth from Germany and France. The ECB recently surprised by dropping its key lending rate to a historic low of 0.25% from 0.50%, concerned also by the undesirable strength of the Euro and the risk of deflation.

Similarly, the Bank of Canada recently surprised markets in October by dropping its forecast for interest rates due to a lacklustre outlook for economic growth. Interestingly, and ironically, Canadian markets have so underperformed their U.S. counterparts, even while our interest rates are similarly at record lows (1% for the Bank of Canada rate), our Federal debt to GDP ratio is much lower at 36%, our Federal deficit is projected to be nil by 2015, our GDP growing likely at 2%, our jobless rate at 6.9% at a 5-year low, and we are rich in natural resources. And, we have already had our version of Obamacare for years.

Japan, still growing slowly, continues with its stimulative interest rate and money printing policies to revive from its deflationary economy of the last two decades. Corporate earnings there are benefiting. So is the Japanese stock market. And wages and real estate prices should start accelerating too, boosting consumption and investment.

Russia just cut its economic forecast for the foreseeable future to 2.5% annually and to only 1.8% for this year. On the other hand, more importantly, in the world's second largest economy, Chinese GDP growth in Q3 accelerated to 7.8%. But, with inflation there at a 7-month high, monetary policy has tightened, driving government bond yields to 9-year highs, to rein in its housing bubble. Expectations are still for 7% growth going forward—lower, but still very impressive. And, over the long run, it is loosening its one child policy and encouraging continued movement of rural Chinese into cities, both to stimulate growth.

A Rocky Road, Inflation and Interest Rates

While interest rates in almost every developed country are at historic lows and supportive of bond and stock prices, the weak growth and, importantly, the low inflation stoking fears of deflation, are prompting the continuing stimulation from central banks. Inflation in the 17 nation Eurozone fell to 0.7% in October, the lowest since '09. Canadian inflation for October was also a concerningly low 0.7% annual rate.

In the U.S., inflation is running at about 1.2%, below the Fed's 2% target, of concern to the Fed, and inducing it to continue its QE program of $85 billion of monthly bond purchases to stimulate the economy and inflation. Meanwhile, there are some disturbing outcomes from stimulation. U.S. house prices are rising, perhaps too quickly. In China and the U.K. also. U.S. government debt at about $17 trillion is equal to its GDP, and still rising, perhaps to $20 trillion by the time Obama departs. Adding in future social security and Medicare payments, total debt is over $100 trillion. The Fed's debt is now almost $4 trillion. Lucky Janet Yellen, the new Fed Chief, a passionate reflationist, just said that the economy and labour market which are performing "far short of their potential" must improve before the central bank can begin reducing monetary stimulus. But these debt levels could be crisis making, which could ultimately result in a declining dollar, and significantly more inflation. And higher interest rates—as we have noted before, very bad for bonds, bad for stocks too—causing declining P/E ratios, though relatively better than for bonds (especially if rising rates are driven by good news) and, much better for commodities and their producers.

To get the Federal debt down would mean the U.S. government would have to increase revenues and cut spending, a prescription for lower growth in the future. But, of course, it could reflate. The reverse of the early '80s policies. The high inflation then (13%) and the combatant high interest rates (16% 30-year U.S. bonds) then instituted by Fed Chairman Paul Volcker were an anomaly. And the historically low interest rates today are also an anomaly, set to address the repercussions of global slow growth, including a Eurozone recession, low inflation and the risk of deflation, and accommodating excessively leveraged government and central bank debt.

Bonds are in a bubble. QE is not infinite, and ultimately, its tapering will have repercussions. Easy money often begets hard landings. Governments and central banks may find themselves between a rock and a hard place.

Rock Garden

There are some bright spots for sure. Cheap and more plentiful energy in the U.S. is one important one. U.S. manufacturing is becoming competitive, to the detriment of Europe and Japan, so that by 2015 more manufacturing jobs could start being created in the U.S. And average labour costs should be better than Japan, Germany and France. A lower U.S. dollar should contribute to U.S. economic growth and better earnings growth. U.S. corporations are strong, with good balance sheets and $1.5 trillion of cash. And U.S. consumers have seen their wealth increase from rising house and stock prices and their balance sheets have also improved with over $11 trillion of total cash on the sidelines.

Our All Cap Portfolios – Key Holdings

Our All Cap portfolios combine selections from our large cap strategy (Global Insight) with our best small and medium cap ideas. We generally prefer large cap companies for their superior liquidity and, generally, lower volatility. We have increased our large cap weighting and foresee a continuing increase. But, our small cap positions are cheaper than the large caps, tracking 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 20 for 20 in its core Stolberg area has helped this company stand out. And, the reserve value is now likely about 40% higher than the current share price. The production and cash flow growth justify an even higher value. Production should be as high as 6,000 boe/d early in 2014 which implies an annualized cash flow run-rate above $70 million or about $1 per share.

The stock price sold off recently after the company announced a major land acquisition, a flow-through financing and the departure of its COO. The financing may have satisfied share demand temporarily and created a bit of supply too as some swapped common shares for tax deductible flow-through shares. The acquisition was not well understood initially and the company was restrained from articulating its rationale until the recent closing of the financing. We see all of this as beneficial to the company. The only material risk we see for Manitok is a decline in the price of oil which does not appear imminent as the price remains below the industry's marginal cost of production. The market has been concerned that the company needed a second area to pursue its growth plans. The recent announcement of the Entice land package purchase from Encana should provide the answer. And, the just announced positive result from Quirk Creek provides yet another area of growth.

Manitok is drilling at least one well per month at Stolberg and expects to begin drilling on its new Entice lands in the next few months. This should continue to drive value. 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 $2.50 share price today. Assuming $85 oil (our conservative figure), in just 3 years Manitok should have annual cash flow of more than $1.80 per share, and at a 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, is another significant holding in our All Cap accounts. The company continues to add to its cash hoard through its remaining operations of its Nathan's hot dog contract which expires in March 2014. After the final expiry of the manufacturing/distribution contract the company should be in a position to return capital in a tax efficient manner to its stakeholders. We expect a further substantial lift from our current carrying value, an estimate determined by a third party valuator.

St Andrew Goldfields has continued to deliver record production levels. Revenues have declined though as the gold price remains near its lows. The balance sheet has over $20 million of net cash (net of all debt) and the stock price is now half of its blow-down reserve based net asset value, and less than one-third of its full net asset value assuming a $1,400 gold price (below the marginal cost of production). Today's gold prices should not last. Commodity prices below the marginal cost of production (the cost to initiate the highest

cost projects) tend to only last several months, rarely remaining below for any lengthy period. We expect a recovery back above the marginal cost of production (~$1,500) over the next several months. Meanwhile, St Andrew's costs have been falling. Its core Holt mine now produces gold at an all-in (including sustaining capital expenditures) cost below $1,000, comparing very favourably to industry peers.

While production is likely to decline temporarily in 2014 as the higher cost mines deplete, profitability should remain robust with about $20 million of cash earnings. The Taylor mine should begin producing gold late in 2014, bringing 2015 production back above today's levels and delivering about $40 million of cash earnings.

A sustained period of lower gold prices could hurt profitability, but is unlikely. 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 reasonably expect.

Orca Exploration's share price has flat lined. The company's $11 per share reserve value appears irrelevant to the market. The company is being shunned for a host of reasons which should all be rectified over the next several months. TANESCO, the national power utility, owes Orca and other suppliers significant arrears. Some have been repaid and the balance should be received soon. The company's Production Sharing Agreement is expected to undergo its long awaited amendment soon too—the uncertainty of which has no doubt contributed to the lacklustre share performance. And, the pipeline in the country, to allow expansion, is now finally being built with its commissioning expected at the beginning of 2015.

Orca has significant net working capital, record production levels, long-life natural gas reserves, operates at low costs with high netbacks and its gas remains in high demand as the company's gas production generates over 50% of the power in Tanzania. We continue to believe that Orca has strategic assets that others will covet. Our valuation for Orca is more than $8 per share or over 3 times its share price.

Dynacor mills gold for other miners in Peru. Its recent quarterly results show some sensitivity to the price of gold but they were entirely offset by increases in amounts milled. The shares trade for about 6x earnings. We expect the company to be running a second larger mill by the end of 2014 which should expand earnings power to over $0.35 per share annually. If the company traded at just 10x earnings, this could more than double the share price based on its milling operations alone, excluding any value attributable to its own exploration properties. The initial results from Dynacor's own gold mining operations have been favourable and its properties should add to overall value whether they're developed internally, by joint venture or sold to a third party.

Corridor Resources' shares appear restrained until a partner (or three—one for each potential mega project) is in place to advance the company's asset value. Meanwhile, natural gas prices have been recovering and Corridor expects to receive a premium of about $2.80 per mcf over prevailing prices from the undersupplied New England market. Now that New Brunswick's new energy policy is in place, Corridor's Frederick Brook shale field is in a better position to sign a partner. With over 1,000 metres of depth, it's amongst the thickest gas shales in North America. More discussions have surfaced over the LNG export facilities in New Brunswick and Nova Scotia which would likely require Corridor's gas feed.

Corridor's Anticosti Island, Quebec shale oil project is also positioned to attract a partner imminently. 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, is awaiting the completion of the ongoing Federal environmental assessment, and both Quebec and Newfoundland appear accepting of the project, allowing it too to attract a partner.

At today's share price we are getting all of the potential mega-projects free because we believe that the value of the McCully field, its infrastructure and net cash alone are worth more than double the share price. Corridor needs partners to bring its major projects to fruition; however, the company's McCully field generates cash flow and with the higher gas prices and $15 million in working capital the company should begin to add value from its core area again.

Legacy Oil + Gas is a light-oil focused intermediate producer with assets in Alberta, Saskatchewan, Manitoba and North Dakota. Almost all of Legacy's production is light oil. The company produces about 20,000 boe/d and just announced another quarter with a 100% drilling success rate. The company's leverage has been higher than we'd prefer but has fallen to a more acceptable ratio and should be at normal levels over the next year as the company spends less of its cash flow. The share price has been recovering, though still appears disconnected to our estimate of its underlying fair value, trading at a 40% discount to our fair market value (FMV) estimate. With a 15-year reserve life, one of the highest in the industry, and continued double-digit production and cash flow per share growth, Legacy is attractive. Our estimate of its current value is over $11 per share and growing by over 15% per year as it exploits its 2,200 net drilling locations. Even at $85 oil, our FMV estimate rises to over $18 in 3 years—nearly 3 times today's share price.

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

Portfolio Changes

In the last few months we sold Arrow Electronics, BMW and Och-Ziff after each of these large cap positions ran up to a TRAC™ ceiling, close to our internal valuations. Goldcorp and NII Holdings were also sold as they breached TRAC™ floors in our work and we may look to repurchase these at lower prices.

We bought *Agrium*, a global retail supplier of agricultural products and a wholesale producer and marketer of nitrogen, phosphate and potash fertilizers, which declined from recent highs as turmoil in the potash sector created pricing uncertainty. However, Agrium's retail operations, including the recently closed Viterra acquisition, are expected to generate approximately $1.3 billion of EBITDA by 2015. Using reasonable multiples for the retail operations, we believe that at the time of purchase we were essentially paying nothing for a recovery in fertilizer pricing driven by the constant need to improve crop yields and feed the world's growing population.

We also purchased *Triumph Group*, a U.S. aerostructure and aerospace systems designer and manufacturer, which stands to benefit from the upturn in the commercial aerospace cycle and is closely tied to Boeing (about half its sales). When the company announced incremental costs related to a specific program, selling by disappointed traders created a buying opportunity for long-term investors. As Boeing and Airbus continue to report major program wins, particularly out of Asia and the Middle East, we expect the shares to return to historic valuation ranges based on the company's unchanged mid-term earnings guidance.

Another new position is *Madison Square Garden,* owner of the New York Knicks and Rangers sports franchises, sports and entertainment arenas and a regional sports cable network, which was trading at a compelling discount to its sum-of-parts valuation. A slam dunk? Perhaps not, but to us it was a 70-cent dollar with substantial cash earnings which affords time for the company to capitalize on its value enhancing options, including initiating a stock buyback and monetizing its air rights. A Dolan family (the controlling shareholder) led LBO is a possibility too should the public market continue to offer their controlled company at a significant discount.

We bought *China Unicom* too, which has over 270 million subscribers and is hardly unknown to Chinese consumers but its less recognized public stock was trading at 80% of FMV or at 14x forward earnings. The Chinese telecom operator continues to post impressive subscriber growth and gain wireless share at the expense of the larger China Mobile. With a more appealing hardware offering (iPhones) and data network, we see this share gain trend continuing. Several tailwinds should help re-rate its shares, including: the continued secular increase in wireless data usage by Chinese consumers, lower interconnection fees paid by China Unicom to China Mobile, and slower and potentially lower 4G capital cost requirements.

We bought *CST Brands* too (detailed in our Global Insight Large Cap section below along with the other such key holdings) 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 reach our estimates of FMV.

Global Insight (Large Cap) Portfolios – Key Holdings

Through October, our Global Insight Long/Short Model (our entirely large cap model), is up 13.8% (USD) and 14.6% (CAD) annualized since inception June 1, 2012, net of all fees. A complete description of the Global Insight Model is available on our website.

National Bank, one of Canada's top banks is our largest holding, though likely to be sold soon. It has run from a TRAC™ floor (and 75 cents on the dollar) when the market seemed to be ignoring its solid growth from the wealth management division, good revenue growth from the capital markets division and stabilization of the bank's net interest margin. Now at a ceiling and nearing our FMV estimate, we are closely monitoring the position for a potential sale.

Vivendi, a telecom and media conglomerate is closing the gap with our sum-of-parts value estimate. The company announced divestitures of Activision and Maroc Telecom both of which account for about 65% of the company's consolidated cash flow. We project a total asset value for equity holders of 20-25 Euros which still represents reasonable upside even though the share price has risen.

Though it's risen too, *Samsung* still trades at less than 8x next year's earnings estimates. We expect both Samsung and Apple to continue to experience strong demand for their smart phone products. 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 share buyback announcement. Our valuation work, which assumes very little growth going forward, implies a fair value which is more than 25% above the current share price.

Both Apple and Samsung fell to buy points in our work on the heels of negative investor sentiment—the market assuming these companies were incapable of ever growing their earnings. Apple is benefiting from a refreshed iPhone, iPad and iPad mini. Trading at just approximately 12x next year's earnings (10.5x ex-cash), a discount to our FMV, Apple shares, like Samsung's, remain undervalued.

Qualcomm has also moved higher and just hit its TRAC™ ceiling. Continued smartphone adoption along with its competitive advantages should keep driving its growth. However, the share price is approaching our FMV and therefore it is a near-term sell candidate.

ING US was a new addition that is also closer to our FMV and just below a ceiling making it a potential sale candidate shortly too. ING US's new management is transitioning the firm's strategic focus from top line growth to return on equity (ROE) and free cash flow maximization. New initiatives put in place by management to hit its ambitious goal of 12-13% adjusted ROE by 2016 are already bearing fruit with adjusted ROE hitting 10% for the first nine months of 2013. We believe ING US can earn more than $3 per share by 2015; our fair value estimate is about $38.

CST Brands was a recent addition. After selling it on a TRAC™ sell signal when it inflected down from a ceiling, we bought it back once it hit a TRAC™ floor. The company is a major convenience store chain that was spun out of refiner Valero earlier this year. CST has minimal analyst coverage and was trading at a price well below our estimate of its fair value.

With the former parent, Valero, completely selling its stake, the incentivized management team at newly listed CST has several compelling projects underway. Initiatives include opening new larger stores with more focus on higher margin products while also shifting the focus away from lower margin cigarette sales at existing stores by dedicating more selling space to fresh food. Our purchase of the stock was at a price that was a 25% discount to our FMV estimate.

Newfield Exploration is currently divesting its international operations (focused in Malaysia and China) in order to accelerate its U.S. oil and gas production. We had originally expected the sale of the international operations to generate a total of approximately $1.2 billion; however, the company has just received 20% more than we had anticipated for its Malaysian assets. These proceeds will be used to aggressively fund production growth from its basins in Utah, North Dakota, Texas and Oklahoma. As a result of better than expected well results, Newfield recently raised its full-year production guidance, which should bode well for share price performance in the near term.

At *Hewlett-Packard* Meg Whitman is quickly undoing the strategic and financial damage caused by prior management. HP is now focused on growth areas such as Cloud, Security, Big Data, and Mobility. HP's net debt is now half of where it was a year ago and even lower than it was before its disastrous Autonomy acquisition. We believe that FY 2013 EPS should mark the trough for earnings and expect the company to return to earnings growth in 2014. Our current valuation is $29 (now close to the share price after its recent rise) though evidence of a sustained turnaround could raise our valuation to $35-$40 per share.

Another tech company we own is *EMC* which provides enterprise storage systems and server virtualization software. After showing weak growth in the quarter, the shares set back to a TRAC™ floor. Trading at a 20% discount to our FMV the shares continue to be attractively priced.

In the last few months a number of positions were sold as they approached our FMV estimates or inflected down from TRAC™ ceilings, including: Intact Financial, Autodesk, Arrow Electronics, BMW, Randgold, Cognizant Technology Solutions, Timken, Och-Ziff, Schlumberger, DeVry Education, Valero Energy, Joy Global and National Oilwell Varco.

A few fell below TRAC™ floors and we sold to avoid further potential declines from those levels: Goldcorp, Newmont, NII Holdings, Dean Foods (which we bought and subsequently sold).

Other new additions in the period included *Agrium, General Motors, Triumph Group, Weatherford International, Ensco, Phillips 66, Suedzucker, Suzuki Motor, Standard Chartered, ING US, Juniper Networks, Madison Square Garden, China Unicom Hong Kong, China Mobile and Credit Suisse Group*—all at floors and at least 20% below our FMV estimates. Some are detailed above in the All Cap Portfolios section.

Income Holdings

Interest rates have jumped up over the last 2 quarters with 10-year treasuries now around 2.75%. High-yield corporate bonds went from a record low around 5% to yield now about 5.9%. Our holdings have an average current annual yield (income we receive as a percent of current market value) of about 9%.

We have witnessed more volatility than usual in our income positions. Our bond/debenture holdings in NII Capital, IBI Group, Southern Pacific Resources and JC Penney have all been relatively volatile. The JC Penney bonds fell on negative rumours, even after the company raised considerable ($900 million) equity improving its credit. However, the bonds have since rebounded nicely. The other 3 companies had weaker than expected corporate results and their bond prices have fallen in sympathy with their share prices. Our assessment of each of these credits is still favourable with asset coverage justifying much higher bond prices. We will however require more patience to allow each of the businesses to show the recovery we anticipate over the next several months. Meanwhile, we continue to believe the asset values of each are well ahead of the debt levels of these enterprises. And we continue to collect outsized interest income from the depressed bond prices. For example, the Southern Pacific 6% debentures have a current income yield of about 12% without even accounting for the gain (from the current price to par) at maturity.

League's notes were set to mature next March. However, the company and its many related entities recently filed for CCAA protection and the court has approved a plan to liquidate real estate assets. We believe that there are potential opportunities for a full recovery on our notes from the net asset value (after the mortgages are paid), though the timing is uncertain.

We continue to look for income opportunities where interest and asset coverage are well above average (to mitigate potential risk of permanent loss) and the return relatively high (both from current income and the potential for capital gain). Our search led us to 3 new positions:

- *Northwest International Healthcare Properties 7.50% September 30, 2018* convertible debentures were purchased at an attractive yield (9% yield-to-maturity) especially relative to the REIT's stable stream of earnings from its international (Canada, Brazil, Germany, Australasia) hospitals and medical buildings. And, should the operations do well, the conversion price is not too far above the current price of the REIT.
- With the rise in interest rates, real estate investment trusts have declined in price from profit taking, after big runs when interest rates were lower and from rising cap rates (the yield of the underlying real estate which is directly impacted by interest rates). This has allowed us to buy into two Canadian REITs at attractive prices: Dundee REIT owns predominantly office properties and yields about 7.8% while trading at about a 20% discount to our FMV estimate, and Calloway REIT, which operates open-air malls, with name brand tenants the likes of Wal-Mart, has a 6.1% yield and also trades at about a 15% discount to our FMV. Both were bought at TRAC™ floors.

Of note, regarding our top income holdings: *Specialty Foods Warrants*, a private company held only in our taxable income accounts, should continue to increase in value (see the reference under All Cap holdings above); the receivables of *Advantex's* business, which are expected to continue to grow, well secure our debentures and we are renewing our position through September 2016 at year end; *Smith & Wesson* bonds have been called and the company is expected to repurchase these from us early in 2014; *Pitney Bowes* preferreds have risen after significant asset sales; *Southern Pacific Resources* convertible debentures continue to drift well below par value as the company's McKay project is delayed though it has shown excellent signs of ramp up in the last few months; *JC Penney* bonds are due in less than 2 years and the company is asset rich given its owned real estate; *Ruby Tuesday* bonds are well covered by underlying real estate too while the company has decent free cash flow; *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.

Rock Climbing

And, talk about different points of view. Jim Rogers, a founder of the Quantum Fund with George Soros, and a venerable investor, believes all the money printing and debasing of currencies, is totally artificial, and will end badly. Andy Xie, a former Morgan Stanley economist, believes the global flow of hot money into government bonds and real estate has created an asset bubble greater than the one that unleashed the 2008 financial crisis, and when the Fed puts on the brakes it will bring on a recession worse than the last one.

On the other hand, economist David Rosenberg believes deflation is no longer a concern and is now bearish on bonds and more bullish on the economy and equities. He sees employment declining, some wage inflation and better economic growth next year of about 3%.

And one of our favourites, John Aitkens, is calling for a re-acceleration of global growth from global policy stimulus, allowing companies to start managing for growth and ROE, and is recommending an overweight in cyclical stocks and an underweight in bonds and defensive stocks.

Rock Solid

Our takeaway. Take advantage of market inefficiencies. Keep looking diligently under rocks for the currently unpopular, cheaper, good values. Today's laggards are often tomorrow's winners. Buy good values to provide a margin of safety. Be patient, it often takes time. Invest, don't speculate. Clearly, avoid low yielding longer-term government bonds—they could be risky. Currently, have a bias favouring cyclicals over fully valued popular companies. Be patient, wait to buy at TRAC™ floors and sell at ceilings. Try to protect by shorting overvalued stocks and/or holding market put options, and cash too for the rainy days. Be skeptical, but flexible, and prepared to change strategies if the circumstances warrant. Do careful analysis, looking under rocks for the values, making sure they really are.

Herbert Abramson and
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