



## **Climbing Walls Carefully**

It's been said that bull markets climb a wall of worry. This one clearly has since the crash lows of March '09, but recently the bull seems to be climbing a wall of optimism. We worry about the optimism. The markets have been making new highs and investor sentiment is high too. Margin debt recently made record highs, though it had its first decline in March after 6 months of rising. And there are clearly some speculative excesses from the bubble stocks, the Teslas, Twitters and LinkedIns. Corporate insiders have continued to be significant net sellers in this period. Time to be wary of a market correction.

### **Tempering Economic News**

Economic news has been improving but it often needs to be tempered when one examines the details. U.S. unemployment just hit a recent low of 6.3%, but was helped by a poor labour participation rate (at a 30-year low) as discouraged people leave the workforce, as when their unemployment insurance entitlements end and they are no longer obliged to seek work. And, average hourly earnings are not rising. Opportunities for young people are weak. Obamacare costs and the potential for a higher minimum wage won't encourage hiring either. Canadian unemployment remains even higher, at 6.9%, with job losses in April.

While U.S. housing prices have reached new highs, housing activity is slowing, from the lower affordability from higher prices and mortgage rates. And, while sales of existing homes rose in April by 1.3%, less than expected, they were 6.8% below the year earlier level. More young people are opting to rent than buy. And the Federal Reserve is concerned over the weakness in housing.

While corporate profits are at a record high it is essentially from record profit margins, abnormally high and likely unsustainable in the longer term. Moreover, the percentage of profit and revenue growth has not been impressive. And productivity output per hour worked is weaker, falling in Q1, the first drop in a year.

While corporate balance sheets are strong, capital spending is anemic. And household debt remains high, which could impede consumer spending. Although April retail sales were stronger, consumer sentiment for May was lower than expected.

Q1 GDP growth was a paltry 0.1% compared to an expected 1.2%, even allowing for the poor weather which was also built into the expectations. And it may even be revised downward to a negative number from a smaller than expected decline in the trade deficit. A drop in both exports and imports hasn't helped. Overall this has been one of the weakest economic recoveries following a recession.

Global economic growth is disappointing too. In the second largest economy, China, its growth and manufacturing activity are slowing, impacted by falling exports, and it's at risk of a serious property market decline. The emerging markets are still in difficulty. Economies such as Brazil, India, Turkey and South Africa are all struggling with negative growth. Clearly, the Ukrainian crisis is impacting the Russian economy and could impact the Eurozone too.

### **The New Normal?**

But economists have assured us this may be “the new normal.” Historically low interest rates and low inflation. Well, the Fed is striving to “normalize” by continuing to cut its Quantitative Easing \$10 billion per month, now down to \$35 billion, but nonetheless assuring that interest rates will remain low for the next two years. Overall prices rose only 1.1% in March from a year earlier, below the 2% Fed target. The Fed is surely concerned about the low inflation and even the potential for deflation, anathema to economic growth as it causes consumers to defer spending.

Inflation in the Eurozone was even lower, 0.7% (compared to its target of 2%), bad for growth and jobs, sparking the European Central Bank to also consider cutting interest rates and other stimulus measures, to combat inflation and to address its concern about the high Euro currency. And the exceedingly high unemployment in Europe. 10-year bond yields in Germany recently fell to their lowest point in a year and 10-year U.K. bonds are at their lowest yield since October. German business confidence just declined.

The U.S. economy and bond and stock markets have been sustained by artificially low interest rates. And when the Fed eventually pulls the plug, who knows? Keeping rates too low for a lengthy period could have negative implications.

The U.S. 10-year Treasury bond yields a measly 2.5%. Low indeed. But imagine, Canada recently issued its first ever 50-year bond, with a 2.75% coupon, and it was oversubscribed. Talk about the new normal—a bond bubble. Most economists expect interest rates to rise in the next several months. This new normal can't last, anomalies don't, and inflation should pick up, perhaps significantly. Remember, renowned economist, Milton Friedman, instructing us that inflation was always and everywhere a monetary phenomenon. But more inflation and higher interest rates will be bad for long-term bond prices and may be a negative for the economy and for stock prices. Higher interest rates can't be good for the Fed and the U.S. government with record high debt levels to service.

### **Economy Improving Slowly**

Don't misunderstand, things in the economy aren't worsening, they're still improving, but slowly, and are not as good as the headline numbers would lead one to believe, nor as good as the stock market has obviously embraced. Importantly, based on our own Trapeze Economic Composite (TEC™) we do not foresee a recession in the near future. But we do anticipate continued slow growth. And, we do believe that the markets are fully valued, and in need of a correction. We aren't expecting a bear market, just a healthy overdue correction from a fully

valued market. Indeed, some stocks are hugely overvalued. A prelude to a correction did manifest itself recently as investors on April 10 unloaded shares of high flying biotech and Internet companies for the worst daily decline for the NASDAQ since 2011.

An enormous amount of cash on the sidelines has been driving the market, with the quantum of shares available shrinking, from corporate buybacks and M&A activity and fewer new offerings.

It's time, we believe, to hold some cash, have some overvalued short positions (in accounts that authorize it) to hedge the decline, and make sure that what we own is adequately undervalued and can potentially withstand a correction.

### **Our All Cap Portfolios – Key Holdings**

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

*Manitok Energy* remains our largest equity holding in most All Cap accounts. Though the company continues to add to its underlying value, the share price is still below our estimated value of over \$4.50 per share, more than 70% higher than the current share price. Production guidance for the company exceeds 7,000 boe/d by the end of this year which should provide a cash flow run-rate of over \$80 million or about \$1.15 per share.

The stock price has underperformed the performance of the business for a host of reasons since last fall. Primarily, there have been concerns, which we believe are wholly unwarranted, about the company's Entice land acquisition and the former COO's departure. Market participants are waiting for Entice results and we expect the company to announce initial well results from Entice in the next few weeks.

Entice, which has the potential to add considerable value, along with continued drilling at Manitok's Stolberg core area, should push value to over the \$6 per share level over the next year, versus its \$2.47 share price, assuming a valuation of \$65,000 per flowing barrel (transactions to buy production have been taking place at much higher prices). A decline in the price of oil, which we do not anticipate, remains the main risk for the company. Assuming \$85 oil (our conservative figure), in just 3 years Manitok should have annual cash flow of more than \$1.80 per share, and a reasonable valuation of 5x cash flow would justify a share price more than 3x today's level.

*Specialty Foods Group*, held in our taxable accounts, is also a key holding. A third-party valuator boosted the valuation significantly in mid '13 and at the end of last year after the company delivered solid results. The valuation is now mostly from the company's substantial

cash balance (over \$50 million). The company should now be in a position to return capital in a tax-efficient manner to its stakeholders. It will likely sell its remaining brands/operations and then return capital to shareholders. We expect the amount of capital returned will exceed our current carrying value as the third-party valuation was conservative. We recently exercised our warrants (for a negligible cost) and now hold common shares entitled to the return of capital.

*Corridor Resources'* share price has bounced significantly since last fall; however, we believe it still doesn't reflect the fair value of the company. Even at today's higher share price, the value of the McCully field, its infrastructure and net cash alone (now about \$35 million) are worth more than the share price. Therefore, the significant potential from Corridor's three megaprojects is still essentially free.

Natural gas prices have rebounded to \$4.50 per mcf as the cold winter and lessened drilling led to drawdowns of North American supplies. Corridor's primary market, New England, was extremely undersupplied in the winter months and the company typically receives a premium of about \$2.80 per mcf over prevailing prices that should be sustainable for several years. The company has already locked in part of next year's production at over US\$11 per mcf—providing an estimated CA\$10 per mcf netback during the key winter months.

Meanwhile, Corridor continues to seek partners for its Frederick Brook gas shale project and its Gulf of St. Lawrence offshore Old Harry project. The Anticosti Island project now has partners—the Quebec government and Maurel & Prom, a mid-tier international oil company—who will spend up to \$100 million drilling on Anticosti Island beginning this summer. Corridor has a carried interest, meaning it is not required to spend on the project over the next couple of years yet it retains 22% of the project. Anticosti Island, Quebec has a projected 33 billion barrels of oil equivalent resource in place—if a mere 5-10% is recoverable it will be successful. The risked value to Corridor is multiples of the current share price. Though, even with extremely promising core samples to date, analogous to the prolific Utica shales of Ohio, lots of work is still required to ascertain whether the project is viable.

Corridor's share price has been bolstered by the company's cash balance and rising cash flow which are sufficient to grow the company again at its core McCully field and to spend modestly on the Frederick Brook shales too in order to attract a partner for that megaproject. Frederick Brook, at over 1,000 metres of depth, is amongst the thickest gas shales in North America and simply needs a partner to advance it, now that gas prices have recovered. If the LNG export facilities being discussed in New Brunswick and Nova Scotia go ahead, each of which would require Corridor's gas feed, it'll really be a "game on" event.

Old Harry has a potential 2 billion barrels of recoverable oil and could also land a partner before long, now that the government environmental assessments are forthcoming.

*St Andrew Goldfields'* production remained near record levels in Q1. While overall production is expected to decline in '14, increasingly, production is coming from the lower cost Holt mine (all-in, including sustaining capital expenditures, costs are below \$1,000 per oz.). And drill results from the Taylor mine project continue to be

impressive. In 2015, production is expected to exceed 100,000 oz. per year with Holt growing and the Taylor mine likely also contributing. St Andrew should deliver respectable cash earnings in 2014 and much more attractive figures next year—about \$25 million. Meanwhile, the company's financial position is strong with about \$19 million of cash after the company just repaid its remaining bank debt.

The share price still trades at a substantial discount to its reserve-only based net asset value—an apparent anomaly considering its next door neighbour, Brigus Gold, was purchased in December at a fair price which justifies a substantially higher price for St Andrew, trading at less than half of its estimated net asset value. Lower gold prices could diminish earnings but gold prices, already below the global marginal cost of production, appear unsustainably low. Our 3-year target for St Andrew remains over twice the share price, assuming a 6x cash flow multiple and somewhat higher gold prices that we reasonably expect.

*Orca Exploration's* share price appears to be coiling for a move upward. Underlying value keeps growing and there is light at the end of the tunnel for the inability of Tanzania to satisfy its financial obligations that have plagued the company. The key risk for Orca is the one that's depressed the share price thus far—a prolonged period of uncertainty. Orca has been restrained by a host of factors; however, each should dissipate in the next several months. The World Bank's involvement, assisting the government of Tanzania, is well underway. TANESCO, the national power utility, has had better income and with some direct funding is in a much better position to repay its substantial obligations to Orca and other suppliers. The new pipeline in the country, allowing expansion of Orca's production, is fully built offshore and now more than half built onshore, with its commissioning expected in about a year. In order to fill the pipeline and limit the brownouts in the country, the government needs to move fast to provide clarity for Orca so it can continue its spending. The election next year and the fact that Orca's gas production generates over 50% of the power in Tanzania should expedite the government to resolve a poor situation.

Orca's cash (it has no debt) represents half its share price and including receivables—from TANESCO—the resultant cash would be more than the current share price. With an estimated reserve value of \$12 per share, the combined value is about 6x (not a typo) the share price. Meanwhile Orca is producing at record levels, has long-life natural gas reserves, and operates at low costs with high netbacks.

After being range-bound between \$5 and \$7 per share for some time, *Legacy Oil + Gas* finally benefitted from the multiple-expansion in the Canadian energy sector and from stock-specific news. The share price should continue to benefit from the large, multi-year development inventory, high netback light oil production with high IRRs and management's intention to use cash flow to both grow the business and reduce leverage.

Two recent developments may have helped too. First, Crescent Point Energy announced a significant Torquay discovery in southeast Saskatchewan. Legacy also has a significant land package (30 to 40 sections) that is prospective for the Torquay formation and investors have extrapolated from Crescent Point's results. Second, the company entered into a deleveraging transaction, announcing the acquisition of Highrock Energy, a Saskatchewan-based private

light oil company with an under-leveraged balance sheet. Production guidance was raised to 22,150 boe/d and exit production guidance to 25,250 boe/d. Perhaps more importantly, management guided to a debt to funds flow from operations ratio of 1.6x, well below the 2.0x debt-to-cash-flow threshold that had concerned the market over the past year or so.

Our estimate of the company's current value is approaching \$12 per share and growing by over 15% per year as it exploits its 2,200 net drilling locations. Despite better recent performance, with the shares currently trading at approximately \$8.50, we expect the discount to narrow even further. Even at \$85 oil, our fair market value estimate rises to over \$18 in 3 years—more than double today's share price.

*Dynacor* continues to generate strong earnings. The share price has rebounded but remains below its highs and *Dynacor* remains significantly undervalued, especially from the effects of the Peruvian government's crackdown on illegitimate miners, which do not include *Dynacor*. Other competitors have been disappearing. And, *Dynacor* expects to be the recipient of a lift in its business as noncompliant competitors fall away. Trading at about 6x earnings estimates, the price is still much too low.

The company is awaiting the final approval for its larger mill which is taking longer than expected as the government is preoccupied with enforcing its newer rules. The approval should arrive this summer and construction should be completed about 12 months thereafter allowing earnings power to climb to over \$0.35 per share annually. At just 10x earnings, this could more than double the share price based on its milling operations alone, ignoring the value from *Dynacor*'s own exploration properties where the company should have a NI 43-101 report later this year which could show an initial resource in excess of 1 million ounces. As long as results continue positively, the company's own production could begin in about 3 years.

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

### **Portfolio Changes**

In the last few months we sold *Vivendi*, *Goldcorp* and *Agrium* after these large cap positions ran up to a TRAC™ ceiling, close to our internal valuations. *American Eagle Outfitters*, *Madison Square Garden* and *Samsung* were sold too as they declined and breached TRAC™ floors. We may look to repurchase them at lower prices. And, we disposed of *Renegade* shortly after the announcement that it was to be acquired.

We also recently added *Honda Motor* and *TRW Automotive Holdings* (both summarized in our Global Insight portfolio review below).

## Global Insight (Large Cap) Portfolios – Key Holdings

Through April, our Global Insight Long/Short Model (our entirely large cap model) is up 10.5% (USD) and 13.9% (CAD) annualized since inception June 1, 2012, net of all fees. A complete description of the Global Insight Model is available on our website.

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

After selling *China Unicom* last quarter when it breached a TRAC™ floor, we repurchased it, even cheaper, when it declined to the next floor below. The company reported an in-line quarter and the stock price has risen back towards our estimated fair value. A good portion of the price rise can likely be attributed to a recent Chinese government proposal for a new centralized cell tower and related infrastructure telco. As proposed, this new telco will build, own and maintain equipment which will be shared by the 3 wireless carriers in the country. Given the increasing focus and cost of data networks, this proposed sharing arrangement should materially lower capital spending requirements for the industry. Even without this new telco we continue to see upside in China Unicom as our estimate of fair value remains above \$20 per share, implying a 25% potential lift. Should the sharing telco form soon, there's another \$5 per share increase in our fair value estimate from lower capital spending requirement.

*Weatherford International*, one of the largest U.S. domestic and international oil and gas services companies, is beginning to deliver on its promise of divesting underperforming or non-core assets and improving the profitability of its remaining operations. Its share price has reacted positively to the announcements of a sequential improvement in its operating margins, identified job cuts to potentially save approximately \$450 million annually, the closure of 20 underperforming locations and an agreement to sell its pipeline and specialty services business for \$250 million. Continued margin recovery and the use of proceeds from asset sales to reduce debt should lead to multiple-expansion back to historic levels of almost 16x forward earnings. Based on the solid results, earnings estimates are rising rapidly, leaving more room for capital appreciation.

*Newfield Exploration*, an independent oil and gas company, headquartered in Texas, is part of a group of U.S.-based E&Ps that have been aggressively selling international assets in order to focus on the development of domestic, higher-growth, unconventional resources. Newfield recently sold its Malaysian operations for nearly \$900 million and is expected to announce the divestiture of its remaining international assets based in China shortly. Proceeds are being redirected to concentrate on its growing production from U.S. basins. Well results from the company's SCOOP play in the Anadarko Basin have been particularly impressive, with five wells in one area averaging about 2,000 boe/d over an initial 24-hour test period and four wells in another area averaging over 1,500 boe/d over an initial 24-hour test period.

With solid drilling results, Newfield's proved reserves increased 8% in 2013. More impressively, the pre-tax present value of the proved reserves (excluding assets held for sale) grew by 44% due to a higher liquids weighting and improving development economics. We continue to expect substantial value creation in the near term as the company's new resource plays are booked into reserves.

*Apple* recently reported results which came in ahead of analysts' expectations from strong iPhone sales. It also announced a boost to its share repurchase program which should result in \$90 billion worth of stock repurchased. Now trading just above \$600, the discount to our \$650 FMV estimate has narrowed. However, our Apple valuation model is conservative and assumes very harsh average selling price declines and decelerating growth rates for its major products. Furthermore, our model does not factor in new products or services that have been long rumoured such as the iWatch or iTV. The company keeps suggesting revolutionary products are in the works and we'll evaluate their incremental potential once announced.

We continue to hold *EMC*, a provider of enterprise storage systems and server virtualization software. Its anemic share price performance can be attributed to potentially disruptive trends in storage technology and a slowdown in enterprise storage. New product cycles for VNX2 and XtremIO and continued success of its VMAX offerings should lead to market share gains and accelerating growth.

*Technip*, headquartered in Paris, France, is a global company that provides project management, engineering, construction and installation for the energy and chemicals industries. After a downward guidance revision during the fourth quarter of 2013, Technip has delivered 2 quarters of results that have met expectations and reiterated targets for 2014 and 2015. With expectations set extremely low, the shares have responded positively. Order intake increased nicely in the most recent quarter (including a major subsea award offshore Angola) and the company's book-to-bill ratio is now well above one, implying solid revenue growth going forward. In fact, the momentum continued subsequent to quarter end with additional significant subsea contract wins. Although the shares have moved up, Technip still trades below its long-term valuation range and at a discount to its peers.

*CST Brands*, the gas station and convenience store operator, continues to improve its profitability mix since being spun out of Valero last year. The share price remains undervalued as the company is still underfollowed and revenue growth has trailed as the company shifts away from certain lower-margin products, like cigarettes. CST's share price saw a boost when its competitor, Susser, was acquired last month. The deal valued Susser at \$2.9 million per store or 12x EBITDA which is significantly higher than our estimated appraisal value for Texas-centric CST Brands.

*TRW Automotive Holdings* is among the world's largest and most diversified suppliers of automotive systems, modules and components to the global original equipment manufacturers. It's primarily focused on safety products, including braking and steering, airbags and seatbelts and electronic control units including crash and occupant weight sensors. TRW trades at a large discount to its auto parts peers despite being in higher-growth segments of the market



and raising its revenue guidance for 2014. Net earnings are also rising rapidly and, excluding special items, TRW reported first quarter 2014 net earnings growth of 20%.

Given its excellent operating and financial performance, the company is aggressively buying back stock, deploying \$400 million of cash through an accelerated share repurchase agreement in the quarter. However, if the valuation discount continues to persist, given its suite of industry-leading and proprietary safety technologies, TRW could become an intriguing takeover candidate for any of its larger peers.

*Apache* is a globally diversified energy company with a portfolio of oil, natural gas liquids and natural gas producing assets in Canada, the U.S., Australia, the U.K. and Egypt. *Apache* is another U.S.-based E&P that is in the midst of rebalancing its portfolio to focus on growing North American liquids production. Through 2013 to today, the company has sold approximately \$9 billion worth of assets including Gulf of Mexico Shelf and deep-water assets, Argentinian assets, and a one-third minority participation in its Egyptian oil and gas business. With the proceeds, management has reduced debt, bought back stock and boosted its dividend.

Over the past several years, *Apache* has lagged its peers due to slowing growth while repositioning the portfolio and multiple-compression related to its Egyptian exposure. However, we believe that management is making the right decisions to position the company for its next phase of growth, which will come primarily from its U.S. basins. Management is currently forecasting 15% to 18% North American liquids growth in 2014. Multiple-expansion should occur now that the company is returning to growth mode and the share price appreciation could even surprise on the upside, given that the unrisks North American onshore resource is four times larger than the currently booked proved reserves.

For decades *Intel* has been the dominant supplier of CPUs for PCs and notebooks. These markets are now in secular decline as mobile devices and tablets have become the preferred computing devices for individuals and even corporations. While admittedly late to respond, *Intel* is shifting its focus to mobile, SoC (System-on-Chip) and Data Centers. We believe *Intel* will eventually make inroads into the mobile and tablet space—which will ultimately be bigger than PCs. Meanwhile, stabilizing PC demand and strong server sales should see *Intel* earn approximately \$2 per share in the next two years and drive the share price higher towards our fair value estimate.

In the last few months a number of positions were sold as they rose to our FMV estimates or inflected down from TRAC™ ceilings, including: Vivendi, Goldcorp, Baker Hughes, Continental Resources, Total, Agrium, Randgold, Orange and Yamana Gold.

A few fell below TRAC™ floors and were sold to avoid further potential declines from those levels: American Eagle Outfitters, Tesco and Newmont.

In the period, new additions—all at floors and at least 20% below our FMV estimates—include the companies detailed below.

With the Nikkei having corrected by 14% during 2014, many Japanese equities look interesting. One Japanese stock we recently purchased is *Mitsubishi UFJ Financial Group (MUFG)*. Mostly known for its Bank of Tokyo brand (Japan's largest bank), MUFG continues to expand around the world with acquisitions in Thailand, the U.S., and Hong Kong. In the U.S., MUFG now ranks within the top 15 financial institutions (its main brand is Union Bank) based on deposits and aims to be a top-10 U.S. financial institution based on profitability and scale.

*Hitachi* is a large industrial conglomerate concentrating on sectors related to "social innovation" including information & telecommunication systems, power systems, social infrastructure & industrial systems, automotive systems, digital media & consumer products and financial services. Despite benefiting from a weakening Yen and weighted toward higher-growth industrial segments, Hitachi trades at a discount to its global peers.

*Honda* shares have fallen over 20% since reporting disappointing 2013 results which saw 3.56 million units sold against expectations of over 3.6 million units. Honda also experienced higher costs related to vehicle recalls. While there is nothing on the immediate horizon to excite investors, as no new full-scale changes to its lineup are expected until the new Honda Civic, the shares now trade at book value, a valuation level seen only a handful of times over the last twenty years, and at a reasonable discount to all of its trading metrics over the last 10 years. We are optimistic about Honda's prospects over the next couple of years as recall issues are tackled, capital expenditures reined in, and new products are expected to be launched.

*First Quantum Minerals*, a Toronto listed company, is a global base metals miner, producing primarily copper and nickel, with operations in Zambia, Australia, Finland and Peru. In 2013, the company acquired Inmet Mining for its Cobre Panama project, which should create significant shareholder value as the mine ramps to full production levels over the next few years.

German financial services firm *Allianz* has been in the news recently due to a high profile dispute between current and former executives at its PIMCO subsidiary. The public mudslinging has provided an opportunity to purchase Allianz shares at 1.1x tangible book value while the sector average is closer to 1.8x. Allianz's Property & Casualty unit is performing well and a growing cash hoard could lead to share buybacks and/or a higher dividend.

U.K.-based *Meggitt* designs, manufactures and maintains components and sub-systems for civilian and military aircraft. On the civilian side, the outlook is rosy; record backlogs at Boeing and Airbus are driving original equipment orders and aftermarket demand should pick up from high current aircraft utilization. Cuts in U.S. defense (approximately 25% of revenue) are being offset by growing Middle East and Asian military budgets.

We reinitiated a position in networking company *Juniper*. Juniper shares were sold at around current levels in January as the stock had run up to our FMV estimate. After we sold, a well-known hedge fund announced it had acquired a stake and presented a plan to cut costs

and boost revenues. We reviewed their plan and concluded, if it were fully implemented, Juniper's FMV could jump significantly from our original estimate. After signs emerged that Juniper's board was willing to discuss the initiatives we repurchased the shares.

*Xerox*, whose business has transformed from a document provider to an outsourcing service provider, continues its ongoing shift to higher margin revenue which should deliver a higher valuation multiple.

Price matching strategies and a revamped online experience have helped *Best Buy* accelerate revenue growth while the company has successfully managed its operating costs. We see this trend continuing while at the same time the overall culture of the firm continues to improve.

Though the Canadian expansion continues to drag *Target's* overall profitability lower, we actually have a positive view of the ultimate outcome of *Target's* options. Either the company, under the leadership of a new CEO, is successful with Canada or it's not and decides to write-off the venture, but earnings accretion should be material whichever option materializes.

With recent shareholder friendly actions including CEO and chairman separation, new CFO, new COO and new brand presidents, *Abercrombie & Fitch's* governance quality has materially improved. With the brand still scoring well with consumers and the company continuing to earn trough margins, the discount between our estimate of FMV and the current stock price offers a margin of safety.

## **Income Holdings**

The 10-year government bond in the U.S. has stabilized at about 2.6% recently. However, we foresee higher rates ahead. High-yield corporate bond rates now yield about 5.4%, and trade near their lows. Our holdings have an average current annual yield (income we receive as a percent of current market value) just below 7%—a bit lower than normal due to our cash holdings as a result of sales over the last number of quarters and finding suitable replacements has been more difficult than usual.

We continue to hold a number of undervalued income positions, a few trading well below par, but with value based on asset coverage which, we believe, justifies much higher prices. And we continue to collect outsized interest income on these positions due to the depressed prices.

We look for income opportunities where interest and asset coverage are well above average (to mitigate potential risk of permanent loss) and the return relatively high (both from current income and the potential for capital gain). However, we have been holding more cash than usual as low rates, particularly in high yield securities, have created a dearth of attractive opportunities. We will continue to explore for opportunities, both via screening and our network of contacts, and patiently await better risk/reward parameters.

We continue to opportunistically add positions and recently added to our list of undervalued Canadian publicly traded REITs. Our REIT basket now yields about 7% with an average 7.25% implied cap rate—undervalued relative to the private markets. During the quarter we added Quebec-based diversified REIT, *Cominar*. We view the 93% tenant occupied portfolio as well managed and conservatively capitalized. We are encouraged with management's ongoing geographic diversification initiatives which we believe will help the units appreciate closer to our estimate of FMV while we collect the REIT's current 7% distribution.

The 7.75% convertible bonds of wireless service operator, *Telecommunications Systems (TSYS)*, were purchased during the quarter. In addition to being the global leader in 9-1-1 call routing for wireless and VoIP network operators, TSYS is also a leader in messaging and wireless location-based services, and provider to government agencies of satellite-based solutions (ground terminals, field support, bandwidth access). With cash flows at cyclical lows we see material upside in pre-tax profits which should translate into higher bond prices. However, even if margins fail to normalize, we are afforded an adequate margin of safety as the company's debt is covered by its monetizable intellectual property by about 200% in our view.

We sold our Pitney Bowes preferred shares after the price lifted and yield commensurately fell to where we were concerned that the risk/reward ratio was no longer favourable. And, we eliminated our NII Cap bonds after they had a decent recovery even though the company continues to disappoint with its results. High-yielding Renegade shares were sold too, as the shares rose when the company announced it was to be acquired.

Of note, regarding our top income holdings: *Specialty Foods*, now an equity holding of a private company, held only in our taxable income accounts, is expected to return capital to us later this year (see the reference under All Cap holdings above); *IBI Group's* convertible debentures should see their value bolstered by the announced restructuring of its holdings; *Advantex Marketing* debentures should benefit from its diversification of additional customers; *Retrocom REIT's* price still doesn't reflect the underlying net asset value which is growing from optimization of its real estate portfolio; *JC Penney* bonds, due late next year, have ample liquidity coverage and its owned real estate provides comfort too; *Ruby Tuesday's* operations have begun to recover while its bonds are well covered by underlying real estate; *Brookfield Real Estate Services* was able to bump its dividend because of its steady royalties based on the increasing number of real estate agents in its network; *Student Transportation* shares trade at slight undervaluation but could easily be the subject of a consolidation with a larger entity; *Dundee REIT* has a stable and diverse stream of income; *Southern Pacific Resources* debentures continue to trade below our estimate of fair value even as the company finally shows signs of recovery.

### **Stock Picking and Wall Climbing**

Our performance is improving and we believe that many of our holdings are prospective for growth over the next year. We have been increasing our weighting in larger cap companies. But it's our Canadian smaller caps, which have been doing better, that have the potential to

reward us significantly and in short order. We are, first and foremost, value investors and are supported by many studies that show that over extended periods value stocks outperform by a large amount. We also have developed proprietary technology to forecast economic recessions and the potential for overall market declines, and to help with the valuations of our holdings and opportunistically time the purchases and sales of these holdings. We believe these tools should meaningfully add to performance.

Bottom line, we are patient investors, unlike the recently criticized high-frequency kind. We strive to buy mispriced securities to give us a margin of safety and be able to endure corrections and await their recoveries. At the end of the day, it's the bottom-up stock picking that dictates most of our returns. And climbing walls carefully.

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