TRAPEZE
ASSET MANAGEMENT

# The Only Game In Town

Our recent quarterly letters cautioned that, as the market was fully valued, a modest correction was likely, and that investors needed to proceed carefully, seeking out undervalued stocks. Yet, the market continued to make record highs. That, despite stretched valuations, public participation at the highest level since '07, margin debt higher than the '07 highs, high insider selling, short selling at the lowest level since the Lehman collapse, and the S&P 500 up for six consecutive quarters and over 1,000 days without a 10% correction—the longest since 1987. Stocks, bonds and commodities all rose in the first half of 2014, even though they are typically not positively correlated. And, volatility in stocks and in bonds was very low, an indication of investor complacency. The Fed itself noted it believed investors were too complacent and was concerned about excessive risk taking.

## Correction Potential

The markets recently began correcting, but have now mostly recovered. Though U.S. small caps are still down 4% from their peak after suffering 9% and 8% corrections ending in May and early August, respectively. The corrective action came despite 75% of U.S. companies beating earnings expectations for Q2. Also, despite satisfactory U.S. economic news, including a better than expected GDP of 4% for Q2, July employment up by 209,000 mostly from private sector hiring—the sixth straight monthly employment up over 200,000—with unemployment up only marginally at 6.2%, and July manufacturing activity at its highest level in over 3 years.

Well, we still maintain the market is fully valued, and vulnerable to the potential correction we have been warning about. And, that recent investor concerns could be realistic. Earnings have been driven, somewhat unusually, by profit margins at all-time highs, likely unsustainable, assisted in part by the low cost of labour, low interest rates, low commodity prices and cost cutting generally. Less so from rising revenues. Corporate earnings now represent more than 10% of GDP. Remember reversion to the mean. U.S. corporations are holding a record amount of cash to fund buybacks and increase dividends. And, of course, share buybacks have helped per share earnings, and M&A activity and a dramatic drop in the number of publicly traded companies have created a lower supply of investment opportunities.

Stock market corrections should become more frequent but leave the bull market nevertheless intact. Under current conditions, compared to other asset classes equities are the best, if not the only game in town. When stocks enter a slump, like that other game, we want to wait for the right pitch. Hopefully when the bases are loaded.

We have our own variation of the equities game. We are value investors. While growth investors tend to look up, as value investors we tend to look down, to assess value and risk. Growth investors tend to gravitate to what's popular and sexy. Value investors are into personality and character. And winning. We want to buy bargains—at least $0.80 dollars and much lower for small caps. We look for undervalued stocks, strong balance sheets, and prospects for growth not reflected in prices. Our game is to seek out mispriced assets, often from being temporarily unpopular, or ignored or misunderstood. Our game is not to speculate, but to analyze, understand and invest. Our game often requires patience but tends to be worth the wait.

**The Big Picture**

In terms of the big picture, the signs for the economic outlook are somewhat mixed, especially abroad. While the U.S. seems to be resuming growth after a weather-driven negative first quarter, it is still relatively slow in Q2 from fewer shoppers even as weather improved and even as unemployment has declined. Consumer sentiment declined in August and retailers have seen a sharp drop in sales. Poor wage growth has restrained consumer spending. And the labour participation rate—Americans looking for work—is at a very low level. Mortgage applications fell 2.2%. New home sales also fell in the first half and should negatively impact home construction and hiring in that sector. July home sales, housing starts and building permits were up, although June pending home sales were down. A mixed bag. Consumer spending could be further impacted, and consumer spending accounts for two thirds of U.S. output. The Chicago PMI for July was down to 52.6, a 13-month low. One would have thought that with all the monetary stimulus the economy would be booming. It's not. The U.S. trade deficit declined 7% in June from declining imports caused by slower demand for consumer goods. But the trade deficit, impacted by a rising dollar, may not continue to decline and likely won't help GDP going forward. Indeed, the International Monetary Fund recently cut its U.S. growth expectations for 2014 to 1.7%, warning of losses to investors from a potential stock market correction.

The I.M.F. also lowered its forecast Canadian growth for 2014 to 2.2%. And the Bank of Canada lowered its own forecast based on the failure of exports to recover, impacted also by a stronger Loonie, though Canada just reported an unexpected rise in exports (and a decline in imports) in June, providing the largest trade surplus since December 2011. Canadian consumer sentiment in August just rose and the revised jobs data for July exceeded expectations. The Bank must be a little relieved.

**The Global Picture**

Around the world, the outlook is for tepid growth too. And most countries would like to help lower their currencies.

China has suffered from a housing slump, and it has been trying to help exports by keeping its currency down, recently by buying record amounts of U.S. treasuries for its foreign exchange reserves. August manufacturing data showed a sharp drop in growth which should encourage continuing stimulus to help it meet its 7.5% GDP growth target. July exports soared 14.5% which will help too.

The Eurozone's economy is not growing and European markets have corrected, with indexes in Europe having fallen around 10%. While Germany's manufacturing continues to grow, business confidence in June fell to the lowest level since October. The sanctions on Russia will impact German growth. Indeed, Germany just had its second consecutive quarterly decline in its GDP growth. Russia, the world's eighth largest economy, from all the sanctions and capital flight, hiked rates to 8% to support the Ruble and will probably have no economic growth. Italy has fallen back into a recession. France's economy is struggling. The U.K. is doing somewhat better, although wage growth recently declined and retail sales are slow there too. The Bank of England, accordingly, is in no rush to raise rates. Unemployment in many European countries, such as Spain and Italy, is still unconscionable. The European Central Bank intends to keep rates low to help, to weaken the Euro further, and to boost inflation which, at 0.4%, is well below its 2% target, and it sees risks in the economy to the downside.

The Japanese trade deficit worsened from weaker exports and its inflation, which it has been struggling to move up, slowed in June. Its economy declined in Q2 from declining consumer spending. Japan has been doing its own quantitative monetary easing to help. And, of course, Argentina defaulting on its debt hasn't helped the global mood. All in all, global economic growth is disappointing. In fact, new Fed Vice Chair Fischer recently said the U.S. and global economic recoveries have both been disappointing. And the game of the drivers at the Fed and Central banks everywhere will be pedal to the metal, to try to increase the speed of economic recoveries.

**Our Strategy**

We rely on our four pillars, including two top-down macro pillars. One of those is TEC™, our economic composite, and it currently does not indicate any forthcoming recession. Nor does our TRIM™ work indicate any new bear market, just a normal constructive correction.

As consummate value investors we will continue to carefully select undervalued companies worldwide, and where authorized, to hedge a potential decline by selling short overvalued stocks and buying puts on an overall market susceptible to decline. And typically to hold a modicum of cash when we are concerned.

We are gratified with our recent performance, and we believe our proprietary tools, both macro and micro, to select undervalued opportunities and to optimize the trading of our buys and sells, should help us outperform the benchmarks.

**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 continue to increase our large cap weighting. 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.

*Specialty Foods Group*, a shareholding in a private company held in our taxable accounts, is preparing to liquidate its assets. Its value is mostly from the company's substantial cash balance (over $50 million). The company will likely be in a position to return capital to its stakeholders beginning later this year. Remaining distributions will likely take place in the middle of 2015 or when the last of its brands/operations are sold.

*Manitok Energy* is our largest equity holding in most All Cap accounts. Our estimated fair market value (FMV) remains above $4.50 per share, more than 60% higher than the current share price. The company is on track to produce over 7,000 boe/d by the end of 2014, an $80 million ($1.15 per share) cash flow run-rate. And, the next few months should help bridge the gap between the stock price and the underlying value. The market has been waiting for Entice drilling results. Initial results showed several oil pools but specific flow rates are still forthcoming.

Continued drilling at Manitok's Stolberg core area and the new Entice area has the potential to increase value to over the $6 per share level over the next year, versus its $2.70 share price. A material 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 3 times today's level.

*Corridor Resources'* core McCully field, its infrastructure and the company's net cash (over $35 million) are worth more than the current share price. The significant potential from Corridor's 3 megaprojects remains essentially free.

Corridor's results over the next few months could help the market's perception of the company's underlying value with drilling taking place at the McCully field, on the Frederick Brook shales, and on cores at Anticosti Island. Corridor now has partners—the Quebec government and Maurel & Prom, a mid-tier international oil company—spending up to $100 million drilling on Anticosti Island. It's still seeking a partner for its Frederick Brook project which, at over 1,000 metres of depth, is one of the thickest gas shales in North America. Corridor continues to seek a partner for its Gulf of St. Lawrence Old Harry project. Though Old Harry and Anticosti have significant promise, much more work needs to be done to ascertain their viability.

Current production is sent to the New England market which was extremely undersupplied last winter. The company typically receives a premium of about $2.80 per mcf over prevailing gas prices that should be sustainable for several years. With higher natural gas prices expected ahead, Corridor's cash balance and cash flow, sufficient to grow the company, and the megaproject prospects, the share price appears too low.

*Orca Exploration* is probably our position with the largest disconnect between price and underlying value. And underlying value keeps accumulating. The disconnect, caused mainly by issues in Tanzania, should dissipate as the issues are resolved. The inability of Tanzania to satisfy its financial obligations has been the most significant issue. The World Bank has been providing aid to the government of Tanzania. TANESCO, the national power utility, has had better income and with some direct funding is now 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 mostly built with its commissioning expected in less than a year. The key risk for Orca continues to be a prolonged period of uncertainty. However, in order to fill the pipeline and limit the brownouts in the country (which would certainly help in the fall 2015 elections too), the government needs to move fast to provide clarity for Orca so it can continue its spending. 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 is equivalent to the current share price. With an estimated reserve value of $12 per share, the combined value is about 4 times the share price. Meanwhile Orca is producing at record levels, has long-life natural gas reserves, and operates at low costs with high netbacks.

*St Andrew Goldfields* just boosted its production guidance for 2014. The Holloway and lower cost Holt mine (where all-in costs, including royalties and sustaining capital expenditures, are below $1,000 per oz.) have been performing better than expected. Drill results from the Taylor mine have been impressive too and we expect next year's production 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. With a market cap, net of $20 million of cash, of only $88 million, the market's appraisal appears too low.

Lower gold prices could diminish earnings but gold prices, already below the global marginal cost of production, appear unsustainably low. The net asset value of the company, even at $1300 gold, is more than twice the share price.

*Dynacor* reported another strong quarter of earnings. Though the quarter still had some impact from the Peruvian government's crackdown on illegitimate miners (most movement of gold in the country was essentially halted for a short time), which did not include Dynacor, the company should 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.

Final approval for its larger mill has taken longer than expected given the government's preoccupation enforcing its rules. However, the approval is expected in the next 3 months and construction should be completed about 9 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, CST Brands* and *Weatherford International*, which are all discussed below in our Global Insight portfolio review.

**Our All Cap Portfolios – Portfolio Changes**

In the last few months we sold Guess, Staples, Aeropostale and Dean Foods as they declined and breached TRAC™ floors.

We recently added *Standard Chartered, Juniper Networks, Volkswagen, Whole Foods, Triumph Group* and *Las Vegas Sands* (also summarized in our Global Insight portfolio review below).

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

Through July, our Global Insight Long/Short Model (our entirely large cap model) is up 11.1% (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.

*China Unicom*, one of 3 dominant competitors in the Chinese mobile telecom market, recently reported a quarter that beat estimates with wireless service sales up 12% and adjusted net profit higher by 62% from the previous year. The company continues to add subscribers, 18 million added YTD bringing its total to about 141 million. Positive industry tailwinds have developed too. The rumored telecom joint venture is moving forward which should lower capital spending for the 3 key operators. Additionally, the largest operator, China Mobile, recently reduced its cellphone subsidies which increased our confidence in near-term rational pricing. China Unicom remains inexpensive even when we apply conservative assumptions to our FMV calculation—and, even assuming minimal growth past the next 36 months, we continue to arrive at a US$22 valuation today.

*Newfield Exploration*, an independent oil and gas company headquartered in Texas, has successfully created significant shareholder value over the past year by monetizing its international assets and focusing on its domestic, unconventional resource base. Although the company has yet to complete the sale of its Chinese assets, the final piece of the international restructuring, we expect this transaction to close shortly. Recent results in the U.S. have been so impressive that 2014 production guidance and its capital budget was raised, with oil and liquids production now expected to grow 30% year over year. Based on solid drilling results in the Anadarko Basin, Newfield added 25,000 net acres in the area and now owns interests in more than 250,000 net acres in this unconventional but developing basin. We continue to expect the pattern of value creation to continue in the near term as the company's new resource plays are booked into reserves by year end.

*Weatherford International*, one of the largest U.S. domestic and international oil and gas services companies, has continued to deliver on its promise of divesting underperforming or non-core assets despite the recent global turmoil. Importantly, the company closed its sale of its Russian and Venezuelan land rigs to Rosneft for approximately $500 million in cash. Further, the recent release of Weatherford's second quarter results demonstrated the improvement in profitability that the market has been waiting for. Operating margin expanded sequentially driven by an improvement in the Eastern Hemisphere operations and a major headcount reduction. Management still has some room to squeeze incremental profits from the business. The combination of margin recovery and debt reduction should lead to multiple-expansion back to historic levels. Based on current earnings expectations, we expect solid capital appreciation through the next year to our FMV in the upper $20s.

We have bumped up our *Apple* FMV estimate to $110 per share ($770 on a pre-split basis). Our Apple model has always been conservative and assumes harsh average selling price (ASP) declines and falling gross margins going forward. We believe such harsh assumptions are appropriate given that the smartphone industry is undergoing constant change with intense ASP cuts and a potential shift in the balance of power back to carriers. Revolutionary products—which CEO Tim Cook has said are on the way—could raise our FMV estimate even further. Though as the iPhone 6 arrives with accompanying hype and as the share price closes in on our FMV estimate we may cull the position shortly.

*EMC's* share price recently spiked after hedge fund Elliot Management Corp. announced a $1 billion stake. Elliot has a history of targeting underperforming technology firms that are ripe for cost reduction programs, spin-offs, and/or stock buy-backs. In EMC's case, they want EMC to spin out its 80% stake in VMware. With EMC trading at approximately $30, we are contemplating exiting. We believe EMC could be worth $35 in a take-out by a tech giant such as Oracle. With limited upside to our optimistic-case scenario, we may swap EMC for a more compelling opportunity.

As we alluded to in past commentary, with *TRW Automotive Holdings* trading well below its peers based on several financial metrics, despite having an industry-leading growth rate, strategic buyers should have been sharpening their pencils. Remember that the company's focus on safety products, including braking and steering, airbags and seatbelts and electronic control units such as crash and occupant weight sensors is high-tech in nature, proprietary and covered by numerous patents. Our thoughts and suspicions were confirmed recently, when the company announced that it had received a preliminary, non-binding proposal by ZF Friedrichshafen, a German automotive supplier, to acquire TRW. Initial reports pegged the value of the bid in the $11 to $12 billion range and potentially as high as $13 billion. These figures worked out to approximately $105 to $110 per share, with speculation that discussions were in the $110 to $115 per share range. Management has engaged Goldman, Sachs as its financial advisor and we anticipate hearing further details in September. However, with the shares currently trading around $100, we are carefully weighing the opportunity cost of continuing to hold our position given various other investment options.

Leading gas station and convenience store operator *CST Brands* reported a dull quarter recently. Fuel margins due to higher inputs costs were blamed. We continue to take a longer term view on CST and are cognizant of the lagged effect of passing along higher oil prices. Much more important, our thesis was strengthened with the newly signed Master Limited Partnership. Going forward CST will sell its newly opened gas station convenience stores to Lehigh Gas, which will supply them with fuel and lease the stores back to CST who will operate the retail business. Cash from the sales of stores will be used to build new stores. To quote the CEO, "We build it, sell it to them, get cash, build it again." This deal provides CST Brands with lower cost capital to help build out its geographic footprint. Our FMV, including the MLP deal, is $40.

Electronics retailer *Best Buy's* shares fell nearly in half in the early part of 2014. With the recent results ahead of expectations and the share price undervalued, given our FMV estimate of nearly $35, we initiated a position. We have been impressed by the company's market share gains, cost savings, cultural changes, price matching and online offering. Simply put, we don't believe the business is going away anytime soon even though its current valuation assumes Best Buy will follow the demise of Circuit City and soon to be restructured RadioShack. The company expects slightly negative same-store sales in the coming quarters, in-line with the industry, but that its cost cutting efforts will offset weaker sales and pricing matching costs.

*Baker Hughes,* like Weatherford—one of the "Big-Four" U.S. domestic and international oil and gas services companies is benefiting from domestic oil and liquids production growth and a global demand recovery for its equipment and services. Second quarter results included 8% revenue growth and operating profits up 15% sequentially while the company repurchased over $200 million of its outstanding shares. Given improving utilization rates in North America and the uptake of products and services developed for unconventional shale basins in new regions such as the Middle East, Argentina, North Africa, Russia and China, we believe that the outlook is very positive. Baker Hughes sees a lift in international rig counts and North American drilling providing a boost to its own business as the provider of innovative technologies.

While the oil and gas services sector is notoriously cyclical and the share prices can be quite volatile, current earnings estimates for Baker Hughes and a more appropriate valuation justify capital appreciation toward our $87 FMV estimate.

**Global Insight (Large Cap) Portfolios – Portfolio Changes**

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: Meggitt, Freeport-McMoran, Asahi Kasei, Occidental Petroleum, Xerox, First Quantum Minerals, Apache, Cheung Kong and Intel.

A few fell below TRAC™ floors and were sold to avoid further potential declines from those levels: Guess, Staples, Aeropostale and Dean Foods.

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

Thanks to previously unforeseen competitive threats, *Whole Foods Market* common shares reached a material discount to our $46 FMV. Rarely are we afforded the opportunity to purchase shares of a high quality retailer with 10% square footage growth and industry high same-store sales near its "no-growth" value. Admittedly, the shares still screen expensively on a price-earnings basis but the company's growth capital spending and material new store opening expenses mask the cash earnings power of this industry leader. We're confident Whole Foods will continue to effectively compete versus traditional grocers thanks to management's new initiatives which include a material remodel strategy for older stores, further price investments to drive value at the store level, a new national marketing campaign and a new home delivery and loyalty program.

With Russia-Ukraine tensions driving the price of WTI crude oil above $107 per barrel and the fear that the U.S. government was about to allow the export of unrefined crude oil (which would have compressed the WTI-Brent spread), expectations for the refinery sector took a hit. As profit expectations declined, shares of the U.S.-based refiners fell in concert. However, as crude oil prices peaked and began to decline, we took the opportunity to sell some our fairly valued oil-weighted E&P holdings and replaced them with two refiners, Marathon Petroleum and Valero Energy.

*Marathon Petroleum* is the fourth largest refiner in the U.S. Midwest with refining, marketing and transportation operations spread across the Midwest, Southeast and Gulf Coast regions of the U.S. The company owns seven refineries and an extensive terminal and transportation system that supplies its wholesale and retail operations. Marathon acquired Hess Retail, which included over 1,200 company-operated locations, a transport fleet, pipeline capacity and undeveloped real estate for nearly $3 billion. The acquisition was consistent with the company's strategy of growing its higher-valued and more-stable cash flow businesses and created the largest company-owned and operated convenience store chain in the U.S. (by revenue), with operations in 23 States. With the shares down over 20% from recent highs and trading at only 8x expected earnings we believe that the market has incorrectly priced the future earnings potential of the company's retail division. Our FMV estimate is about $107.

The other selection from the refinery space (although not the first time we've owned this particular name) is *Valero Energy*. Valero is the world's largest independent refiner with 16 geographically diversified refineries (2.9 billion bpd throughput capacity), 11 ethanol plants (1.3 billion gallons per year total capacity) and more than 7,400 retail outlets branded under the Valero, Shamrock, Ultramar, Texaco and a few other trademarked names across the U.S., Canada, the Caribbean, the U.K. and Ireland. Importantly, the company's significant presence on the Gulf Coast allows Valero to export refined petroleum products worldwide and steal market share from less competitive refiners around the world. Again, with the shares down approximately 18% from recent highs and trading below 8x expected earnings, we believed that the fear and pessimism was overdone and it created a buying opportunity before the shares revert back toward our $65 FMV estimate.

Also in the energy space, we redeployed capital to beaten down *Southwestern Energy* when natural gas fell more than 20% during this relatively cool summer. Southwestern is the fourth largest natural gas producer in the U.S. lower 48, primarily from the Marcellus and Fayetteville basins. Despite relatively weak natural gas prices, the company grew production 18% while maintaining profitability in its most recent quarter due to the low-cost nature of the its operations. In fact, relative to the realized natural gas price of $3.65 per mcf, Southwestern has reported a 3-year average lifting cost below $1.00 per mcf and a 3-year average finding and development cost of approximately $1.50 per mcf.

In addition to the profitable E&P business, we are intrigued with the company's midstream operations. Southwestern's Fayetteville shale gathering system, comprised of almost 2,000 miles of gathering lines and 560,000 HP of compression equipment, and Marcellus Shale gathering system, comprised of approximately 60 miles of gathering lines, are expected to generate adjusted EBITDA of over $375 million this year. Based on the MLP structure used to surface value by other E&Ps and refiners, we believe the company could create significant incremental shareholder value by monetizing its midstream assets while awaiting a rebound in the natural gas price from seasonal lows. Our FMV estimate is $53.

*CA Technologies* is the largest independent provider of IT systems management software operating across all platforms including mainframe, physical, virtual, on and off-premises. CA's common shares trade at a favorable valuation which compensates us for its slowing mainframe business. We're encouraged by the company's aggressive new product introductions and more importantly its continued focus on cost management. Our FMV estimate is in excess of $34.

*Aflac* operates in 2 geographic segments, Japan and the U.S. It offers supplemental insurance products such as cancer, general medical indemnity, ordinary life insurance plans, annuities in Japan and short-term disability plans in the U.S. During the quarter Aflac's discount to our $80 FMV widened. With a leading distribution network and recognizable brand, Aflac consistently produces 20% returns on equity—quality and undervalued. These features should allow the company to once again gain favour among investors.

*Mizhuo Financial Group*, the second largest financial services company in Japan, trades at just 9x estimated earnings per share and 85% of book value. There are no company-specific issues to warrant its undervaluation. Investor concerns are macro related; low long-term interest rates, European debt situation, and falling domestic loan-deposit spreads are chief among them. Peers Mitsubishi UFJ (which we also own) and Sumitomo Financial are also undervalued. Admittedly, we see no immediate catalyst to warrant a re-rating to book value or above. Over time, though, rising contribution from faster growing overseas markets, higher rates, and internal synergies ought to lead to a rebound in investor sentiment.

*Standard Chartered* is an international bank with operations in Africa, Asia, and the Middle East. Rising regulatory oversight and costs, deterioration in its loan book and a weak operating environment has soured investor sentiment. We acknowledge these issues but we also see positive signs that management is dealing with these challenges. In its first half report, the company recorded a 16% rise in loan loss provisions and a $3.4 billion rise in its highest credit risk loan category. On top of this is a depressed capital markets environment which led to a 20% decline in Financial Markets revenue (its second largest division after retail banking). Despite this, the bank's Tier 1 equity ratio remained relatively unchanged at 10.7% (well above the required minimum) and tangible net asset value rose 3% from year end. The bank also managed to generate an adjusted return on equity of over 10%. Barring a new global recession or severe downturn in financial markets, the environment is unlikely to worsen. Standard Chartered's shares, down 40% from their 2010 high, more than discount these issues. Our value is at least £15, or roughly 80% of adjusted book value.

*Volkswagen* shares have been volatile as of late after a report surfaced that it might bid for Fiat. The report has been denied by both companies and we view a merger as unlikely. The Wolfsburg-headquartered company does aim to be the number one car company in the world but it is already on course to overtake Toyota without a merger. Its namesake brand has hit rough spots in a few markets around the world but its higher-end—and higher margin—brands such as Audi, Porsche and Bentley are performing well. China remains its key market. Volkswagen continues to hold on to the top spot in China with a 14% share. Our estimate of fair value is €210.

Speaking of *Fiat*, we bought it too. Its lineup includes autos and light commercial vehicles under the Chrysler, Jeep, Dodge, Ram, SRT and Fiat names. It also offers accessories under the Mopar brand name. Its Fiat segment also manufactures and sells Ferrari, Maserati, Alfa Romeo and Lancia. The company's products are distributed through its dealer networks in approximately 40 countries. Once the cloud lifts over the company's merger with Chrysler, the stock price could migrate back toward our €9 valuation.

*Las Vegas Sands*, with over 85% of its revenue from faster-growing non-U.S. markets, declined after short-term issues recently negatively impacted Macau casino operators. With the shares down almost 20% from its March peak, we acquired them at a 25% discount to our $90 FMV.

We're confidently looking past near-term Macau weakness thanks to Sands' organic growth that will outpace its market growth, its license to operate within Singapore's gaming duopoly, the ongoing cyclical recovery in the Las Vegas market and several greenfield market opportunities.

**Income Holdings**

The 10-year government bond in the U.S. has fallen to around 2.4%. Concerns about an economic slowdown, no outward signs of inflation and Chinese bond buying have all likely contributed to the Treasury bond rally. We still foresee higher rates ahead. High-yield corporate bond rates have simultaneously increased and now yield about 5.6%. Our holdings have an average current annual yield (income we receive as a percent of current market value) of approximately 8%. 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, lower 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 purchased the 7.75% 2021 bonds of privately held *Sun Products* for our taxable accounts. With a greater than 10% yield-to-maturity we are adequately compensated for the near-term competitive pressures from Tide. Sun Products offers various branded consumer products under the Sunlight dish and laundry banner, as well as Wisk, All, Surf and Snuggle.

*IBI Group* has reported several positives since our last update. First, the balance sheet has been addressed by (i) extending our convertible series from 2014 to 2019, (ii) an asset sale closing this quarter and, (iii) extending the maturity date of its revolver. Second, the operations have improved, as witnessed by the recent margin gains due to the company's restructuring and cost containment. Additionally, IBI's accounts receivable over 90 days declined again. We recently exchanged our 2014 notes for 2 new bonds; a 2016 7% and a 2019 7% bond. The 2016 notes equate to 20% of our original par amount while the 2019 notes represent 100% of our original par amount.

We recently purchased *American Eagle Energy* 11% 2019 senior secured notes. The company, a U.S.-based Bakken oil producer, raised US$175 million and the offering was priced to provide an 11.25% yield-to-maturity. Although the debt position is relatively large compared to the company's current equity market cap of $180 million, we believe that the reported proven pre-tax net present value of reserves (discounted at 10%) of $336 million is solid and should easily cover our notes. Further, the company has successfully grown production from a negligible amount in 2012 to 2,300 boe/d today through the development of formations that are well understood after years of exceptional production results. With an average cash margin above $50 per boe, we look for cash flow to ramp significantly and leverage ratios to normalize quickly as the company continues with its development plans.

The *League Opportunity Fund* notes were to mature in March 2014. However, in October 2013, the company and its many related entities filed for CCAA protection and PricewaterhouseCoopers Inc. (PWC) was court-appointed as the Monitor. We recently wrote down the carrying value of the notes from $85 to $30 based on our revised recovery estimate. Our write-down reflects updated information provided by League and PWC, including lower real estate sales estimates, higher liabilities and a liquidation plan rather than a previously considered restructuring plan, which could have provided time to improve properties for potentially higher recoveries. The timing of recovery remains uncertain though the bulk of distribution may be made within the next 12 months. We continue to work with lawyers to enforce our clients' rights with a view to maximizing the recovery.

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); *Advantex Marketing* debentures should benefit from the company's diversification of additional customers; *JC Penney* bonds have responded to improving company fundamentals and the protection provided by its liquidity and owned real estate; *Retrocom REIT*'s price still doesn't reflect the underlying net asset value which is growing from optimization of its real estate portfolio; *Ruby Tuesday*'s operations have begun to recover while its bonds are well covered by underlying real estate; *Student Transportation* shares trade at a slight undervalution but could easily be the subject of a consolidation with a larger entity; *Brookfield Real Estate Services* continues to benefit from its steady royalties based on the increasing number of real estate agents in its network; *Dream Office REIT* (formerly Dundee) has a stable and diverse stream of income; *IBI Group's* debentures have seen their value bolstered by the company's completed restructuring.

**The Only Game In Town**

Inflation in the U.S. rose 1.6% in June, below the Fed's 2% target for a 26$^{th}$ consecutive month, and deflation is still a big concern for it and for central banks around the world. Though Fed tapering of its bond buying is set to come to an end in October, the Fed still intends to keep rates ultra-low, probably until mid-2015, and is somewhat encouraged by an improving labour market. Apart from its deflation concerns, its own balance sheet has $4.5 trillion of debt and the Federal debt at some $17 trillion dollars is equal to the U.S. GDP. Both needing to be serviced going forward with low interest rates. And the I.M.F. is also urging the Fed and other central banks to keep rates low.

With the 10-Year Treasury at a 2.4% yield, the real return is minimal. The comparable bond in Germany yields 1%, in France 1.4% and in Spain 2.4%. Imagine, the same in Spain as the U.S. Talk about the running of the bulls. These are the lowest rates in centuries.

Investors have been driven to equities because that's where they believe they will be treated the best, with fixed income markets providing negligible nominal and real returns, especially compared to an even higher dividend paid by some large companies, and especially compared to returns on an after-tax basis, where capital gains on stocks and dividend returns get preferential treatment to interest income. Long term bonds will be much better for government and corporate borrowers than for the lenders. And even ultra-long bonds, that mature in more than 30 years, have become more prevalent. Indeed, even companies flush with cash, such as Apple and Google, are borrowing at these low rates. Some of that money used to buy back shares. Carpe diem.

We have believed that the artificially low rates have created somewhat of a bond bubble, and that all the money printing will likely result in devaluation of money, i.e., higher inflation, ultimately leading to higher rates and to bond losses.

It may be, that with slow growth, low interest rates will be maintained longer than we have contemplated, but it is still not without the risk of unforeseen consequences, particularly of higher inflation. Remember stagflation?

Taking all into account, as we stated, we concur that equities today are likely the best, if not the only game in town. At these artificially low rates the bond game may be Russian roulette, and that should also require sanctions. Investors should be astute to buying the stock bargains that corrections present. Investor concern had been rising, which is a positive. This bull market is likely not over, just needs to pause, so buy the dips as they say. And buy cheap stocks, not the stock market.

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