RISK AND REWARD

There is always risk in investing in public markets, whether in equities or fixed income, or even cash. As value investors we seek to minimize the risk and maximize the reward by buying significantly undervalued securities with solid businesses and the potential for above average upside. And, indeed, our equity-based portfolios attempt to exemplify that philosophy, buying large cap companies at least 20% undervalued, and, in our All Cap mandates, small caps at least 40% undervalued to compensate for the greater illiquidity and volatility of smaller cap companies.

Macro Risks

Recently the risks however have come not from the micro aspects of our holdings (that is, not from their balance sheets or business prospects for example, most of which are good and progressing) but from the volatile macro factors: the dramatic decline of prices for oil, precious metals and commodities generally; the strength of the U.S. dollar from the ending of quantitative easing by the U.S. Fed; and, recently, the massive quantitative easing by the Bank of Japan (which dropped the relative value of the yen). These factors also include Japan having just fallen back into recession, the slowing of China's growth and Europe's continued malaise, and most disconcerting, the threat of deflation throughout the developed economies. Inflation in China, for example, is below 2% compared to its 4% target; it just cut its interest rates to stimulate growth and lower its currency, especially versus the yen. Manufacturing and inflation data from the Eurozone, the world's largest economy, is worrisome, and the ECB is actively looking to take remedial steps. Reflation and stimulus are the orders of the day.

This has created an environment of continuing ultra-low interest rates almost everywhere throughout the developed world, with some obvious exceptions such as Russia (9.5% to support the declining ruble) and 11.25% in Brazil where inflation is excessive. The CPI in the U.S. is currently 1.7%, below the Fed's target. The 10-year U.S. Treasury bond yields a miniscule 2.3%. One-third of S&P 500 stocks yield more than bonds.

To be sure, the economic news isn't all bad. U.S. Q3 GDP improved to 3.9% and U.S. retail sales rebounded during October. Leading economic indicators were up 0.9% in October and existing home sales were better than expected. U.S. unemployment at 5.8% is the lowest since mid '08 although wage growth is still lagging. Canada's jobless rate fell more than expected to 6.5%, a 6-year low, although, as in the U.S., the labour participation rate was very low.

Fighting Deflation

Real returns on government debt are negligible or non-existent and imply risk if interest rates were to rise—which they might soon, if economies were to improve and rates were adjusted upwards by central banks, or if the battle against deflation by central banks were to make progress and result in rising inflation. This could result from the competitive currency devaluations everywhere currently, except for the U.S. The Chinese yuan (the second largest economy), the Japanese yen (the third largest economy, at 7-year lows) the Euro and our own Canadian dollar have all been declining recently versus the U.S. dollar. This is gratifying to those economies with declining currencies to help stimulate exports and inhibit deflation. In the end it may not be gratifying to the U.S., as it will likely ultimately inhibit GDP growth by exacerbating the trade deficit and making the U.S. a less attractive place for manufacturing investment and for U.S. exporters generally. GM plans to invest $12 billion in China over the next 3 years to increase its manufacturing capacity. And you have to believe the Fed is concerned and may not raise rates by mid '15 as anticipated. A stalemated U.S. government from a Republican Congress and Democratic President may also ultimately lead to weakness in the dollar, although, on the plus side, Republican efforts could result in lower corporate taxes and encourage corporations to bring back the $2 trillion parked overseas to avoid higher taxation.

But not only can a relatively low domestic currency help combat domestic deflation and stimulate those economies by discouraging imports and encouraging exports, inflation also allows heavily indebted countries to repay their debt with deflated currencies. And that debt is currently monstrous. Global debt relative to GDP is currently up by some $30 trillion, over one-third since the financial crisis of '08, and a record amount of more than twice global GDP. High debt levels are often a cause of asset and economic declines. A real macro risk.

Bifurcations

These macro risks, and their perceptions by investors, have created some bifurcations with investors chasing perceived safety. As we said, bond markets have remained strong notwithstanding negligible returns and potential risk. Safe dependable consumer stocks have been sought notwithstanding their high, often excessive, valuations. Although not all large safe dependables have been so safe recently, suffering from the macro disparities. Witness Coca-Cola, IBM and McDonald's struggling from slow international growth.

Cyclicals and commodity stocks have suffered from the recent declines in energy and precious metal prices and commodities generally. And, resource-based small cap stocks, usually at valuation discounts from their large cap brethren, have continued to suffer as investors crave liquidity. Sentiment for commodity producers and, especially, for small cap resource stocks, is dreadful. On the other hand, sentiment levels for stocks generally indicate excessive enthusiasm, warranting caution. Margin debt in September was close to its all-time high set earlier this year. The U.S. markets have been the preferred markets with the Dow and S&P 500 making record highs after an earlier correction, but, trading at over 18x trailing earnings, are not cheap. Yes, U.S. corporations have had record profitability, but are using ultra-low cost debt to buy back shares and enhance per share earnings. And high stock prices have fueled a merger boom with global M&A volume over $3 trillion this year. Yet, sales growth forecasts have declined to 2.6% for Q4 and companies continue to benefit from high margins and slow wage growth. Until they don't.

But those bifurcations, while creating pain for investors, clearly create opportunity for patient value investors such as us who focus on bottom-up value investing in healthy businesses. More evidence of bifurcation—only about a third of the issues in the S&P 500 beat the overall gain of the S&P, meaning the gains are concentrated in fewer issues—tough for money managers.

Predictability

From a macro standpoint, we don't believe low oil prices—below the marginal cost of production—are sustainable. Low oil prices will inevitably beget higher oil prices as production is discouraged and consumption stimulated. Prices at the gas pump are already at 4-year lows, encouraging driving, and giving the consumer additional funds to spend. Airlines and other transportation companies clearly benefit. Retailers too, from lower distribution costs and higher traffic.

The real risk in betting on macro outcomes is their unpredictability. Will the economies start to grow? Will disinflation stop? Will quantitative easing be effective? Will global debt stop increasing? A famous economist once said, "If you must predict, predict often."

While buying equities is not without risk—especially commodity related equities exposed to the fluctuations in price of what they produce, and more volatile small caps—it is still desirable for patient investors to opportunistically buy these grossly undervalued businesses with strong balance sheets, good cash flows, good managements and great prospects for future production growth.

Inflection Points

We may be at important inflection points for markets. The Dow and S&P 500 at record highs and not cheap. Interest rates at record lows, so bonds are not cheap. Energy and other commodity prices at multi-year lows and likely not to decline much further. And, other than the U.S. dollar, currencies generally are at unsustainable lows. Time for caution and time for opportunity. Value investors tend to be contrary. Often though, as now, it's tough to be contrary in the face of such long trends. It's been said about markets that the trend is your friend, but when it's as extended as today, it's likely not.

We are also in tax loss selling season which clearly aggravates many share prices, such as in the already depressed energy sector, creating even better bargains.

At these record highs the market is fully valued and overbought (too much optimism/complacency), and therefore vulnerable to a modest correction again. Along the way, a number of our large cap holdings rose to our estimate of their fair values and therefore we sold them. With very few large caps sufficiently undervalued (i.e., around 80 cents-on-the-dollar) and selling at floors in our TRAC™ work, buying opportunities are low and our cash positions have risen. We continue to seek opportunities to reinvest this cash especially since stock market corrections may become more frequent but nevertheless leave the bull market intact.

Our Strategy

We always seek bargains—at least 80 cent dollars and much lower for small caps. We look for undervalued stocks, strong balance sheets, and prospects for growth not reflected in prices. We seek out mispriced assets, often from being temporarily unpopular, or ignored or misunderstood. Our approach is not to speculate, but to analyze, understand and invest. Our approach often requires patience but tends to be worth the wait.

We rely on our four pillars, including two top-down macro pillars. One of these 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 the prospect of 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 where the overall market is susceptible to a decline. And typically, we will hold a modicum of cash when we are concerned.

Our largest exposures, in both the Global Insight (our large cap model) and within our All Cap mandates, are to commodity producers, mostly oil and gas companies and gold producers.

We are attracted to these sectors for a number of reasons. First, from a top down perspective, oil and gold prices, along with numerous other commodities, are now selling below their marginal cost of production (the costs of the bottom decile producers) and even less than many producers' average all-in cost of production.

Prices at these low levels would appear unsustainable because Economics 101 would remind us that supplies should begin to dwindle and therefore force prices higher once producers are facing losses. Oil and gold are both about 20% below their marginal cost of production. Normally, the marginal cost itself is a floor, other than in major dislocations, which does not appear to be the case today.

Also, we appear to be at a major inflection point for many asset classes. The U.S. dollar is grossly overbought and at a ceiling in TRAC™, while at the same time oil and gold are enormously oversold and at floors in our work. Oil, for example, has only been this oversold 2 other times in the last 20 years, each of which marked a multi-year low.

The only material negative influence on oil prices recently appears to stem from U.S. supply increases, production now above 9 million bbl/d. However, at today's oil prices, nearly half of the U.S. shale fields merely break even, suggesting a floor is near.

And, as important as the top down considerations, from a bottom up perspective, the oil and gold sectors are amongst the cheapest around the globe. In our Global Insight process, we regularly rank over 1,000 of the largest companies in the world by valuation—cheapest to most expensive. We then rank the sectors too. Oil and gas service companies, oil and gas production companies and gold producers stand out for their low price to value. As typically happens in the financial markets, the stocks overshoot. Oil producers are now discounting even lower than prevailing oil prices. And, senior gold producers are trading at 80% of their book values, the lowest in over 30 years, close to the level seen at the depths of 2009.

As contrarians, more importantly, as investors who focus on both the bottom up and the top down, now appears to be an unusually good time to invest in companies in these sectors.

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 look 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 complete the liquidation of 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 in the next few months. Distributions will likely take place by the middle of 2015.

Manitok Energy is our largest equity holding in most All Cap accounts. Our estimated fair market value (FMV) remains above $4 per share, more than double the current share price. The net asset value of the company ascribed by its third-party engineers, using a 10% discount rate and conservative energy prices, was $3.80 per share last March. Since then the company has made material discoveries at its Entice property. The company's share price took a hit beginning in late August when it lowered year-end guidance from just over 7,000 boe/d to just over 6,000 boe/d, due to temporary tie-in constraints for its newly found Stolberg production. But the company is back to record production levels, having tied in the Stolberg production at the end of October. And, its Entice wells, which have so far been beyond expectations, should be tied in shortly too, bringing the company's original guidance back within reach.

The disconnect between the stock price and the underlying value is just too wide. Results at Entice have shown several new oil pools but with the backdrop of declining oil prices and the early stage of these results, the market has been unwilling to price in the newly found value.

Development drilling from Stolberg and Entice have the potential to increase value to over $5 per share by the end of 2015, 3 times today's share price. We have suggested that the key risk for Manitok has been a fall in oil prices. That risk has clearly diminished. From today's oil price level, it would be unlikely that much further declines are ahead. Assuming $85 oil (our estimate for oil prices), 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 5 times today's level. We find it hard to believe others won't see the same thing shortly and Manitok's price will accordingly adjust upwards.

Orca Exploration is another position with a large disconnect between price and underlying value. In Orca's case, the disconnect is primarily caused by the situation in Tanzania. The government's inability to satisfy its financial obligations to Orca and its lack of progress in clarifying a path for Orca's business plans have restrained investor sentiment. The World Bank has been providing aid to the government of Tanzania. TANESCO, the national power utility and Orca's primary customer, 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 by mid '15. However, the government has been mired in a corruption scandal which has prolonged the period of uncertainty. 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 fact that Orca's gas production generates over 50% of the power in Tanzania should expedite the government to resolve a poor situation. But the government has shown little interest in making progress.

Orca's cash (it has no debt) and receivables—from TANESCO—are in excess of 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 near record levels, has long-life natural gas reserves, and operates at low costs with high netbacks. Though the company has announced that there have been unsolicited expressions of interest in all or parts of its assets, until some of the uncertainty dissipates, even sophisticated corporate buyers may be unlikely to step up.

Corridor Resources' core McCully field, its infrastructure and the company's net working capital are worth more than the current share price. The significant potential from Corridor's 3 megaprojects remains essentially free.

We will likely have to wait patiently though for the underlying value to surface. When the Liberal party in New Brunswick came to power recently, it suggested it would place a temporary ban on fracking. Hopefully it will be temporary, or Corridor's projects, on which Potash Corp. is dependent, are perhaps exempted. Meanwhile, drilling at the McCully field, on the Frederick Brook shales, and on cores at Anticosti Island should continue to add value. Corridor now has partners—Petrolia, 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. Interestingly, the new government is meeting with Repsol to understand the gas export opportunity for a project that would be the largest ever in the province's history and is likely to require supply from Corridor. Corridor needs a partner for its Gulf of St. Lawrence Old Harry project which it should get when permitted. Old Harry and Anticosti have significant upside but much more work needs to be done to ascertain their viability.

We expect New England, where Corridor sends its current production, to be extremely undersupplied again this winter. The company has received a premium of about $2.80 per mcf over prevailing gas prices and that should be sustainable for several years. With higher natural gas prices expected, Corridor's sufficient cash balance and cash flow, and the megaproject prospects, the share price appears too low. Though, clarity to the fracking issue would help to see growth continue uninterrupted.

St Andrew Goldfields' share price has suffered for 2 reasons. First, gold prices are near a multi-year low and earlier in the year the company lowered its production guidance. The gold price now appears unsustainably low and production guidance has been lifted back near record levels. The Holt mine, where all-in costs, including royalties and sustaining capital expenditures, are below US$1,000 per oz., has been performing better than expected and drill results from Holt and from the Taylor properties have been impressive too. Next year's production should exceed 100,000 oz. per year with Holt growing and the Taylor mine likely also contributing once the final bulk sample is completed over the next month or so. Even at today's gold price, St Andrew should deliver free cash flow in 2015 of over $14 million and much higher figures in 2016. With a market cap, net of $20 million of cash, of only $75 million, the market's appraisal appears too low, especially when the company earns substantially more at higher gold prices, which appear likely given that half of the producers globally have all-in sustaining costs above today's unsustainably low gold prices. The net asset value of the company, at $1300 gold, is more than twice the current share price.

Dynacor reported a weaker quarter of earnings from a declining gold price. Though, as a miller, not a miner, of gold, the company is much less susceptible to bullion price movements. The company has no debt and about $14 million of cash. Net of the cash, it's trading at only 6x its lower run rate of earnings from this quarter. We sold about one-third of our position at higher prices a couple of months back and replaced it recently after the share price declined.

The company continues to await approval for its larger mill which has taken longer than expected given the government's preoccupation enforcing the rules against small non-compliant miners and millers. However, the approval is still expected to be forthcoming and construction should be completed about 9 months thereafter allowing earnings power to climb to over $0.40 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 soon which could show an initial resource in excess of 1 million ounces.

Though you wouldn't know it from the share price, the operating performance at *Legacy Oil + Gas* continues to impress. Masked by declining oil prices, Legacy again delivered another quarter with a perfect drilling success rate, with production reaching an average of 25,000 boe/d, an increase of 28% from the comparable quarter last year and an increase of 24% from last quarter. Production has already exceeded the company's exit guidance of over 27,000 boe/d. In the current quarter, the company plans to spend only 60% of cash flow on capital expenditures, using the balance for debt reduction. Coupled with the sale of Legacy's Elmworth property, year-end net debt is forecasted to be 1.9 times fourth quarter annualized cash flow, which should be within investors' comfort zone. Considering Legacy's reported net asset value of approximately $11.70 per share, based on December 31, 2013 reserves, under $4 the stock trades at too high of a discount to its fair value.

Our top holdings in our All Cap portfolios also include positions in large caps *China Unicom*, *Triumph Group* and *Honda Motor* which are all discussed below in our Global Insight portfolio review.

Our All Cap Portfolios – Portfolio Changes

In the last few months we sold EMC, TRW Automotive Holdings, Madison Square Garden, Apple, Whole Foods Market, CST Brands and Target as they all lifted to our fair value estimates and TRAC™ ceilings. We also eliminated Juniper Networks, Las Vegas Sands and Standard Chartered as each declined and breached TRAC™ floors.

We recently added *KKR & Co., Abercrombie & Fitch, Goldcorp, Viacom* and *Leucadia National* (also summarized in our Global Insight portfolio review below).

Global Insight (Large Cap) Portfolios – Key Holdings

Through October, our Global Insight Long/Short Model (our entirely large cap model) is up 6.5% (USD) and 10.5% (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. Since inception, our long positions have returned as expected. The realized gains on our "longs" have been above 20% annualized. The overall performance has been inhibited by cash, shorts, puts and unrealized losses in the September/October correction.

China Unicom, one of 3 dominant competitors in the Chinese mobile telecom market, reported a mixed quarter in October. Larger competitor China Mobile appears to be winning some higher value customers back from Unicom; however, Unicom's cost containment drove EBITDA margins to a 5-year high. With a significant drop in costs reported in its most recent quarter and decent revenue growth in the next 3 years, we remain confident in China Unicom's long-term free cash flow growth. Our estimate of fair value is over $20 per share.

Newfield Exploration, despite the ongoing correction in the price of oil, has continued to build shareholder value. The company monetized assets and used proceeds to repay debt. Impressive results for its latest quarter exceeded the mid-point of prior guidance. U.S. domestic liquids production, now more than half of total production, increased 7% sequentially and 38% on a year-over-year basis. Importantly, Newfield has a significant hedge book in place and, should oil prices remain around current levels, the company expects to realize nearly $50 million of pre-tax income per quarter from derivatives through the end of 2016. Over the next few months we expect the sale of its China business and a favourable update to its 3-year strategic plan. Our FMV estimate is $50 per share.

Marathon Petroleum, the fourth largest refiner in the U.S. Midwest, benefits from lower crude oil input costs; therefore, shares have rebounded and currently trade close to all-time highs and close to our estimate of fair value. The company's retail division, Speedway, recently acquired Hess' retail operations and now operates over 2,700 gas stations across 22 states.

Even excluding the impact of the acquisition, Speedway's income from operations increased 17% on a quarter-over-quarter basis, driven by higher gasoline and merchandise margins. Marathon also announced plans to accelerate the growth of its related midstream MLP and authorized the sale of the remaining pipeline stake. Finally, the company continues to return capital to shareholders via meaningful share repurchases. Continued growth in the retail division and additional asset drop-downs to the MLP coupled with share buybacks should push the stock toward our FMV above $100 per share.

Although *Weatherford International*, one of the largest U.S. domestic and international oil and gas services companies, has yet to experience any reduction in service activity, shares declined precipitously along with the price of crude oil before rebounding slightly. Perhaps the news of a mega-merger in the oil services space was sufficient to put a floor under all of the stocks in the sector. Meanwhile, Weatherford has continued with its planned asset sales—Russian and Venezuelan land rig operations and its Pipeline and Specialty Services business. The sale of underperforming businesses and continued cost reduction initiatives in the remaining businesses resulted in a core operating income margin increase from the prior quarter. Weatherford will likely benefit from M&A activity through accelerated asset sales or could even become a target itself. One way or another, we expect management to be able to crystallize enough hidden value to get the shares to our FMV in the mid $20s.

Fiat's share price was unusually volatile from the nuances of its Chrysler merger which ultimately closed without a hitch. More recently, the announcement to spin off Ferrari once again proves CEO Marchionne's capital market prowess. The spin off should enable the Ferrari brand more freedom to expand its strategy, possibly increasing its production and enter new verticals. However, the market remains overly skeptical of Marchionne's ability to hit his 5-year financial targets for the combined Fiat Chrysler group. We continue to estimate fair value at $15.

We recently took advantage of the opportunity to purchase *Cablevision* shares below our $22 fair value estimate, due to investors' concerns with Verizon's increased competitive offering which has led to subscriber losses at Cablevision. Cablevision is the 5th largest U.S. cable operator with more than 2.7 million subscribers in the New York metropolitan area and enjoys industry leading penetration and bundling metrics. Even though subscribers have been lost to Verizon, Cablevision's plan to focus on higher value customers while lowering its operating costs has actually expanded its free cash flow.

Triumph Group, an aerospace parts and systems manufacturer, had faced several headwinds, including lower build-rates and cost overruns on some of its key platforms at the beginning of 2014. However, management worked hard to correct these issues and pushed ahead with the transition to a new, more efficient manufacturing plant in Texas. Management's focus on execution, cost improvement and cash generation allowed them to reduce outstanding debt, make a small, tuck-in acquisition and repurchase shares in the most recently completed quarter. With the operations back on track, when management reaffirmed its fiscal 2015 revenue and earnings guidance and forecast continued free cash flow (available for further debt reduction, acquisitions and share repurchases), the stock jumped nicely. Once the company delivers several quarters of solid operating performance in a row, the stock should reach our FMV estimate in the low $80s.

We took advantage of the early October sell-off and purchased shares in holding company *Leucadia National*. The company is a conglomerate with most of the assets in investment dealer Jeffries, though it has a wide range of other businesses. Trading at an almost 30% discount to our sum-of-parts estimate, we were attracted to Leucadia's margin of safety but we also see upside to our $30 FMV estimate. Founders Ian Cumming and Joseph Steinberg have taken backseats while the entrepreneurial executives from Jeffries will look to continue their legacy by deploying capital opportunistically.

We also purchased shares of specialty chemical company *Eastman Chemical* after its stock drifted lower subsequent to a disappointing Q2 earnings report. The primary concern for investors was a decline in the company's organic growth profile. Eastman's organic growth run-rate has declined over the last few years. However, while others were focused on the delta of the growth rate, we calculated that the implied growth rate of the stock at our purchase price was close to only 1%. We believe that Eastman's earnings growth will be much higher than 1% in the coming years. Our near-term FMV target is $95.

Private equity firm *KKR* has nearly $100 billion of assets under management and a proven track record of success dating back to 1976. We bought shares after its stock price declined more than 15% since the beginning of the year. A number of positive elements at KKR are being ignored by investors. Its recent acquisition of KKR Financial Holdings, a specialty finance company, decreases its dependence on private equity deals and provides a big boost to the percentage of distributable income derived from recurring income. The improved liquidity from higher public investments and the transparency and consistency that a recurring income stream provides should lead to a higher earnings multiple. Another catalyst will be the launch of second generation funds that currently have over $10 billion in AUM. Our sum-of-the-parts valuation is over $30 per share.

We continue to hold shares of *Honda Motor*. We purchased Honda earlier in the year after its shares declined by over 20% due in part to costs incurred from vehicle recalls. Now Honda finds itself front and centre in the Takata air-bag debacle that has impacted several auto companies. We see these issues as temporary and downside limited with shares trading near book value, a valuation level seen only a handful of times over the last twenty years. Our fair value estimate for Honda is approximately ¥4,500 which equates to 1.3x book value and 11x our estimate of 2015 earnings.

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: EMC, TRW Automotive, Best Buy, Conagra Foods, Madison Square Garden, Apple, Whole Foods Market, Mizuho Financial, Mitsubishi UFJ Financial, CST Brands and Target.

A few fell below TRAC™ floors and were sold to avoid further potential declines from those levels: Las Vegas Sands, Valero Energy, Aflac, Southwestern Energy, CA Technologies, Corning, Standard Chartered and Juniper.

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

We purchased shares of teen retailer *Abercrombie & Fitch* after watching the company make key merchandising improvements combined with endorsing shareholder friendly actions. We believe management is correct in de-emphasizing its logo assortment and comforted by the continued reduction in inventory per square foot. Other long-term positives include adding new brand presidents, accelerating corporate cost cutting, closing underperforming stores and increasing e-commerce investments. Other positives include separating the CEO and Chairman roles along with continued stock repurchases. At the current valuation we believe investors are getting any margin improvement as a free option as the shares are now inexpensive based on Abercrombie's current below average profitability. Our estimate of fair value is $45.

We comfortably looked past the recently reported noisy quarter from *AIG*, the leader in P&C insurance, life & retirement services and mortgage insurance, and took the opportunity to purchase shares at 70% of book value. AIG is arguably more manageable than any time in its history while it has several material margin improvements ahead. Levered to rising interest rates we view the risk reward as very compelling. Our estimate of fair value is $70.

Casino Guichard Perrachon, an international grocer operating in France, Brazil (GPA), Colombia (Exito) and Thailand (Big C) has nearly 80% of its profit coming from emerging markets. In its home market, France, Casino operates several retail formats including hypermarkets, supermarkets, convenience and discount stores. The recent IPO of Casino's e-commerce retailer Cnova offers further upside potential. Under conservative assumptions for Casino's non-listed entities we estimate the sum-of-parts value at €105.

John Malone controlled holding company *Liberty Media* owns over 58% of satellite radio operator Sirius XM, significant stakes in Live Nation, Time Warner, Viacom and the Atlanta Braves. We purchased shares as the stock was offered at an attractive 20% discount to our valuation estimate based on a sum-of-parts—each of which we view as fair to undervalued as well. With the recent Broadband spin off, Liberty's structure is more straightforward and fair value realization appears achievable in the medium term. Our FMV estimate is $42.

SAP SE is the world's largest provider of enterprise software and software-related services. Like competitors IBM and Microsoft, SAP is transitioning its business model from one built around a traditional hardware/software sales cycle to one focused on cloud and SaaS (Software as a Service). We believe that SAP's cloud and SaaS vision is more focused than its competitors with cloud-based revenues on pace to exceed licensing revenues over the next five years. Our FMV is approximately €65.

We repurchased *Prudential Financial* after shares declined to under 10x 2015 estimated earnings per share. Shares have treaded water for more than a year despite book value growing by 11% and ROE hovering above 16%. We believe the market is currently too focused on the interest rate environment and ignoring the positive fundamentals of the business. No doubt the rate environment has become marginally more dovish as of late. However, Prudential has demonstrated that it can run its business effectively—and achieve a high ROE—in a low interest rate environment. Higher rates, likely ahead, will provide a tailwind for earnings growth. Our FMV estimate is $112.

Since gold looks to have found a bottom, we used the indiscriminate selloff in the sector to add two high quality names. We purchased *Goldcorp* and *Randgold Resources* as they shared three key criteria: low cost production, improving balance sheet and a clear path to above average production growth. Goldcorp is currently forecasting all-in sustaining costs toward the low end of the guided range of between US$950 and US$1,000 per ounce, while Randgold's are about US$1000 per ounce. Even at current commodity prices, Goldcorp expects to generate free cash flow in 2015, while Randgold has already reached free cash flow status and actually paid off its remaining debt in the current quarter. Goldcorp remains in a net debt position, but with its major mine development capex completed, leverage should fall meaningfully going forward. Goldcorp is forecasting 2014 production growth of 9% to 15%, while Randgold is forecasting growth of between 24% and 30%. Both of these stocks trade at significant discounts to our FMV estimates using reasonable long-term gold price assumptions.

Also taking advantage of the declines in the commodity space, we established a position in *Halliburton*, one of the "big-four" U.S.-focused oil and gas service companies. We expect crude oil prices to rebound and drilling for the commodity to continue unabated in order to offset relatively high decline rates, particularly in various U.S. basins in order to meet ever-rising global demand. Apparently Halliburton's management team also sees good value in the sector as, shortly after we acquired our stake, it made a takeover offer for one of our other holdings, Baker Hughes, at a decent premium. Although shares of Halliburton declined on the news (and shares of Baker Hughes spiked) we believe that FMV for the combined entity could be as much as 40% higher from today's price as "new-Halliburton" builds sufficient scale to compete more effectively against the market giant, Schlumberger.

After selling *First Quantum* this past summer when it rose to our FMV target, we recently took a position in the copper miner again when its price also declined with other commodity-based stocks. First Quantum operates mines in Zambia, Mauritania, Spain, Finland, Australia and Turkey that produce copper, nickel, zinc and gold. The company is also currently developing several mines in Zambia and the Cobre Panama project. We believe that the shares had become overly punished by the market, falling 40% from peak to trough, in the ongoing market correction exacerbated by reports that the government of Zambia was looking to unfairly change the royalty and tax regime in the country. In response, various producers have threatened to mothball currently producing mines and development projects, thus depriving the government of cash flow. Should reason prevail, we expect the shares to rebound toward our estimate of FMV in the high teens to low $20s based on a long-term copper price assumption of $2.80 per pound (less than the prevailing price).

Jacobs Engineering Group is one of the world leading providers of technical, professional and construction services to industrial, commercial and government clients. It operates under a relationship-based sales model, admittedly with higher expenses than some of its peers, and as a result over 90% of Jacob's work is repeat business. The backlog currently stands at approximately $18.5 billion and has been rising steadily since the recent cycle low in 2010. Importantly, Jacobs represents a relatively defensive name in the sector and the stock has generated free cash flow on a trailing-twelve-month basis every single period since the last recession. We estimate a current FMV in the low $60s.

We regard the current viewership slowdown at media giant *Viacom's* MTV and Nickelodeon properties as cyclical and addressable. Viacom's affiliate fee revenue (from cable companies), remains extremely consistent and unaffected from the recent viewership declines. We purchased shares at a 25% discount to our $95 fair value estimate. While we wait for the viewership turnaround we are aligned with a very shareholder friendly board of directors as Viacom continues to produce a 10% shareholder yield from annual buybacks and dividends.

Income Holdings

The 10-year government bond in the U.S. sits just above 2.2%, about the same level as 3 months ago though it's been volatile and dropped as low as 1.9%. Concerns about an economic slowdown, the Fed policy stance and disinflation continue to keep rates low. We continue to believe higher rates are coming. Meanwhile, high-yield corporate bond rates have lifted again to just over 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 continue to explore for opportunities, both via screening and our network of contacts, and patiently await better risk/reward parameters.

We purchased 4.875% *JAKKS Pacific* convertible notes due 2020 at an attractive 7.2% yield. JAKKS is a designer and marketer of toys and consumer products based on popular entertainment property licenses. Limited trading liquidity has created mispricing. The yield was too high given JAKK's low net debt and high level of insider equity ownership. Recent results give us even more confidence in JAKK's credit risk as the company reported 12% revenue growth and 20% net income growth while raising guidance materially for the current quarter. The common equity appears significantly undervalued which may provide upside to the 2020 convertible bonds as the valuation gap narrows.

We sold our JC Penney bonds after they jumped in price based on improvements in its overall business. And, we eliminated our Southern Pacific debentures, even after they declined substantially, concerned that the company would be unable to have the time to complete its business plan given the slow progress at its oil sands project.

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 shortly (see the reference under All Cap holdings above); *Advantex Marketing* debentures should benefit from the company's diversification of partners and merchants; *Ruby Tuesday*'s operations have begun to recover while its bonds are well covered by underlying real estate; *Sun Product* bonds (a private company held only in our taxable accounts) has benefited from better earnings; *Retrocom REIT*'s price still doesn't reflect the underlying net asset value which is growing from optimization of its real estate portfolio; *Student Transportation* shares trade at a slight undervaluation but could easily be the subject of a consolidation with a larger entity; *American Eagle Energy* bonds trade below where they ought to because of slumping oil prices; *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* has a stable and diverse stream of income.

Bonds have become risky. So too have some large blue chip companies. 3M, Disney, Nike and others have elevated to valuation levels where an investor is unlikely to have gains looking out over the next few years. While they may be terrifically-managed and growing enterprises, the valuation levels are far above that justified by their underlying profits. A carefully selected portfolio of undervalued positions is even more critical in today's market.

The Reward

All things being equal, bigger is better, but all things today are not equal. Don't misunderstand, our own Large Cap - Global Insight Model is very attractive, buying undervalued companies—and it makes up for the better valuations of small caps with the ability to trade the large caps more frequently when they reach ceilings/targets and replace them with other undervalued large caps.

Buying the growing, safe businesses of small caps for 40-50% of their FMVs usually requires patience, especially because they are small and underfollowed, and often, as is the case today, unpopular. But temporary unpopularity creates value. The ultimate outcomes are more predictable, merely requiring a tolerance for short-term, sometimes painful, fluctuations. Trading off volatility for patience. It works. Because typically when value surfaces and becomes evident, investors are rewarded.

Herbert Abramson and
Randall Abramson, CFA
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