TRAPEZE
ASSET MANAGEMENT

THE BIG PICTURE

As consummate value investors we are continuously seeking individual stocks and bonds that are trading at mispriced undervaluations. At 80%, or less, of our estimated values for big cap stocks and, say, 50% for small caps. Looking up and down for value.

However, these days we need to look up more intently to the macro picture, which is complex, historically unusual, and volatile, and which has helped some big cap stocks, the so-called safe dependables (for their low volatility and yield), while hurting others, the cyclicals and commodity resource producers, and small caps generally.

The big picture, the global economic condition, is characterized by record high debt levels, an unusually slow recovery from the '08 Great Recession, ultra-low interest rates from stimulative measures taken to combat deflation, competitive currency devaluations, and deflation concerns in most regions.

The International Monetary Fund has cut its forecast for 2015 global growth, indeed, for every major economy, including Canada, except for the U.S. whose growth forecast it raised to 3.6%. And high debt levels are a major issue. Even though many governments, including the U.S., are not expanding their fiscal deficits, U.S. debt is still equal to its GDP. Thankfully better than Greece, whose debt is 175% of its GDP. Total global debt is up $57 trillion since '07 to $199 trillion, the biggest increase coming from government debt, with China accounting for more than one-third of the increase. Whenever interest rates begin to normalize, the cost of servicing the excessively high debt levels could become overly burdensome.

The big picture also needs to account for the economic impacts from the turmoil of radical Islamic terrorism in the Middle East and North Africa, the Syrian war, the sanctions against Russia from its aggression against Ukraine and the potential departure of Greece from the European Union with the risk that others such as Portugal, Spain and Italy might follow.

Pedal To The Metal

Central banks everywhere are on the case, pushing hard for growth and to combat deflation by debasing their currencies through ultra-low interest rates. The ECB just implemented Quantitative Easing saying it was ready to buy over $1.1 trillion of sovereign and asset backed bonds between March 2015 and September 2016. Pedal to the metal. Sweden, Switzerland, Denmark and the European Central Bank now even have negative interest rates on bonds with maturities up to 6 years. The 10-year German bond yields 0.3%, France 0.6%, Japan 0.3% and Canada 1.3% after it lowered its key interest rate in January to 0.75%. Deflation is an economic negative in that it discourages consumers from spending currently believing that prices will be lower in the future.

Japan was the poster child for that phenomenon as it experienced a lengthy recession and deflationary period, with consumers, after years, suffering mortgages higher than the value of their properties. Now Europe is emulating Japan. A lower Euro (down over 20% against the U.S. dollar since last May) will help exporters and keep deflation in check from higher import prices.

This period has also recently witnessed low commodity prices, whether the effect of slower economic demand or, in the case of oil, more likely from U.S. shale-led excess supply and from political motivations of OPEC. Imagine, oil prices dropping more than 50% since June. And oil equities, of which we had our fair share, suffered big time, though recently there seems to be a reversal at hand. Our work suggests that the oil price has likely bottomed and should improve. And the price of gold too. Especially since both commodities trade below their average global cost of production. The beaten up producers, especially those with stronger balance sheets, should recover smartly.

Proceed With Caution

The U.S. economy has been the global standout, though GDP growth for Q4'14 declined from Q3 to 2.6%. Unemployment is now at an improved 5.7%, though wage rate growth is still lagging. And January consumer confidence is higher at 98.2 although, paradoxically, retail sales slumped in January, even with savings at the gas pump and improved household savings. The extreme winter weather is obviously impacting too.

With low interest rates from low inflation, the U.S. 10-year treasury yields only 2%. U.S. stocks are at record highs. The U.S. dollar continues to rise, lowering inflation. And recently, a rarity, the dividend yield on the S&P was higher than the 10-year Treasury bond. The Fed continues to defer the date it will raise rates. It wants to spur inflation and does not want an even stronger currency which is deflationary and hurts exporters. Witness the recent negative impact from the stronger dollar on the earnings of Procter & Gamble, Microsoft and Pfizer. Understandably, the trade deficit is growing and should restrain GDP growth.

With that background where does an investor go? We think bonds are risky. And that the U.S. dollar index is at a ceiling and that other currencies, including the Yen, the Euro and our Canadian dollar are at floors, although, it is possible that a continuing global deflationary slowdown could result in an even higher U.S. dollar.

We also think U.S. stocks are generally fully valued, with the S&P 500 at 18x forward earnings, half of them with P/E multiples over 20x, and with earnings growth slowing. Profit margins are abnormally high and share buy backs have held up per share earnings. Analysts' consensus estimates show no sales growth for the S&P 500 in 2015. It is getting harder to find stocks that meet our value criteria. And if the Fed raises rates it could lead to lower price-to-earnings ratios.

With central banks generally pushing to keep rates low, depressing their currencies and stimulating economies, global economic recovery might accelerate. Q4 saw a modest increase in GDP for the Eurozone, with Germany and Spain recovering somewhat, although Italy and France were still languishing. China, the second largest economy, is slowing too, to the lowest growth since 1990, and is stimulating with easier monetary policy. Russia is in recession. Japan is just starting to recover from its recession. The UK economy is doing better but the Bank of England is also concerned about low inflation.

Our Risk Monitors

All that said, 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 looming recession. Nor does our TRIM™ market risk work indicate any new bear market, just the prospect of a normal constructive correction. It's said that the market climbs a wall of worry. The current wall seems higher than normal and the market keeps climbing. Regardless, we actively monitor our economic composite in the U.S. and abroad for signs of caution and similarly keep a close lookout for TRIM™ risk alert signals, where only a handful of stock markets have breached. In other words, it's not yet time to head for shelter.

Though, with few large caps undervalued enough (i.e., around 80 cents-on-the-dollar) nor at floors in our TRAC™ trading work, we are carrying higher than usual cash positions. We continue to scour our universe of over 1,000 of the largest companies globally, looking for opportunities to invest. Better values should arise in a normal correction.

Meanwhile, if our macro red flags do alert us, we won't be shy, where authorized, to hedge a potential decline by selling short overvalued stocks and/or buy puts when the overall market is susceptible to a decline. And, hold more cash and fewer cyclicals.

Compelling Small Cap Value

Our small cap holdings are extraordinarily cheap. Although the current carrying value of Specialty Foods is based, in large part, on the company's cash holdings, our expected payout later this year could still result in a 10-30% lift from our current carrying value. Orca trades at less than its cash and receivables so its downside appears minimal while, at one quarter of its NAV, the potential upside is high. A peer comparison shows both St Andrew and Manitok as the cheapest in their respective sectors. Manitok, our only key small cap holding with any debt, trades at 2x expected EBITDA vs. a median of 6x for its group, while St Andrew trades at less than 2x EBITDA vs. nearly 7x for its peer group. Dynacor trades at only 8x temporarily depressed net earnings and around 4x prospective earnings excluding any value from its own exploration properties. Corridor may take more time to play out, but trades at half of its book value, with net cash and assets that should be worth well in excess of its historical book value.

We continue to be comfortable holding this group until they revert close to fair value. Although these smaller, less liquid holdings are potentially more volatile, the risk of permanent impairment appears minimal while upside potential remains higher than ever. We elaborate on each holding below.

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 lower volatility. Importantly, they tend to recover back to their fair values much faster so they can be traded more frequently for enhanced returns. We continue to increase our large cap weighting. However, our small cap positions are cheaper, trading 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. It has placed $40 million (of its more than $50 million cash) in trust, earmarked for shareholders. The company will likely be in a position to return capital to its stakeholders beginning in the next few months. We anticipate partial distributions will likely take place by the middle of 2015 with the balance later in the year.

Orca Exploration is our largest equity position, mostly because its price has been stable while others have declined, though Orca exhibits one of the largest disconnects between price and underlying value. The disconnect is a function of the situation in Tanzania—namely the government's inability to satisfy its financial obligations to Orca and the lack of clarity for Orca's business moving forward. Thankfully, there are signs that clarity should arrive shortly. The World Bank has been providing aid to the Tanzanian government. TANESCO, the national power utility and Orca's primary customer, is now in a 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 commissioning expected this summer. Government officials who have been mired in corruption scandals have recently been ousted. The IFC just proposed allocating $60 million toward Orca's $120 million expansion plans. In order to fill the new pipeline and limit the brownouts in the country, parties are now pulling together to advance Orca's spending. Orca provides over 90% of the natural gas to Tanzania which generates over 50% of the country's power.

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 the uncertainties dissipate further, even sophisticated corporate buyers may not step up. We are reminded of one of our former partner's comments that, in some companies you wait 5 years and then make all your money in 5 minutes. Orca is a candidate for this notion.

St Andrew Goldfields' share price has rebounded recently but is still well below our estimate of its fair value. The lift in the price of gold, especially in Canadian dollar terms, augers very well for St Andrew. The company's production in 2014 was 91,000 ounces, not too far from its record results of 2013, and should be back into record territory this year. The Holt mine has performed to expectations and Holloway keeps delivering ounces. Meanwhile, its newest mine, Taylor, has just been given the go-ahead to move toward production. The results from Taylor have been excellent with the recent bulk sample showing 9 g/t. The company's overall reserves and resources jumped by 25% too, further extending mine life. Even at today's gold price, St Andrew should deliver free cash flow in 2015 of over $15 million and much higher in 2016. With a market cap, net of about $22 million of cash, of only $90 million, the market's appraisal appears too low. The company obviously will earn substantially more at higher gold prices which appears likely given that around half of the producers globally have all-in sustaining costs above today's unsustainably low gold prices. St Andrew has staying power. Its last 14 consecutive quarters have been cash flow positive and its net cash position keeps building. The net asset value of the company, at today's gold price, is more than twice the current share price.

Corridor Resources' core McCully field, its infrastructure and the company's net working capital are worth more than the current share price. And, though we appear to be getting the significant potential from Corridor's 3 megaprojects essentially free, a good deal of the potential upside will be dependent on the New Brunswick government's temporary fracking moratorium being lifted.

We will have to continue to wait patiently for the underlying value to surface. We believe the recently elected New Brunswick Liberal party's temporary ban on fracking will prove to be short-lived. Perhaps a year. It would appear highly unlikely, given the lack of evidence against fracking, that there would be permanence to the ban. Furthermore, the significance of this major gas resource to the province is also a factor. Even if a ban were to remain in place, there could be exemptions. Corridor's fields are far from populated areas and fracking is at depths that do not impact the water table. Potash Corp., which operates a significant business and a large employer in the province, is also dependent on Corridor's main gas field. Finally, the Premier met with Repsol to understand the gas export opportunity for a New Brunswick based project that would be the largest ever in the province's history. Repsol has now submitted a plan for a Saint John LNG export terminal. It would be extremely hard for the government not to embrace this project. And it's highly unlikely that New Brunswick wouldn't want its own gas resource, which would be required for the facility, to be supplied locally from Corridor and any others in the region. But, the timing around the ban is uncertain.

Meanwhile, we will continue to get results from stratigraphic cores at Anticosti Island—which should continue to add value. Corridor and its partners—Petrolia, the Quebec government and Maurel & Prom, a mid-tier international oil company—are spending up to $100 million drilling on Anticosti Island. A potential partner for its Frederick Brook project, which at over 1,000 metres of depth is one of the thickest gas shales in North America, will likely need to await relief from the fracking ban.

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.

The New England market, where Corridor sends its production, remains extremely undersupplied. 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, obviously, clarity to the fracking issue is needed to see growth continue.

Dynacor, as a miller, not a miner, of gold, 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 8x its run rate of annual earnings from its most recent quarter.

We have been waiting for approval for its larger mill which has taken much longer than expected given the government's preoccupation enforcing the rules against small non-compliant miners and millers. However, the approval is 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 an NI 43-101 report soon which could show an initial resource in excess of 1 million ounces. Recent drilling results, including independent verification, have shown the potential prospects for a significant high grade property.

Manitok Energy's share price has suffered recently from the decline in energy prices and its production delays. At these low levels, the price of oil appears unsustainable because supplies should begin to flat-line or even dwindle and force prices higher as demand is ever growing. The only material negative influence stems from U.S. supply increases. Since nearly half of the U.S. shale fields merely break even at today's oil prices, a floor should be imminent.

Most importantly, the company has made significant discoveries. However, as they were from new areas, production glitches occurred—the most recent finds at Stolberg last summer weren't tied in until the end of October, and the newly discovered Entice wells, which have so far been beyond expectations, have encountered facility limitations too, though they should be alleviated reasonably quickly.

Results at Entice have shown several new oil pools but, with the backdrop of declining oil prices, limited history of these results and the operational lags, the market has been unwilling to price in the newly found value. 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. Though the commodity pricing used for the December 2014 NAV will obviously decrease the figure, the material discoveries at its Entice property should help offset the price related decline. And ongoing development drilling from Stolberg and Entice should continue to increase value.

The key risk for Manitok has been the decline in oil prices which impacts cash flow and, in turn, valuation. With oil so far below the average cost of production and the number of drilling rigs plummeting, it would be unlikely that much further declines are ahead. While the company has about $77 million of debt, because it has oil and gas price hedges in place limited capital spending for the first half of 2015, debt should fall to around $65 million (less than 2x debt/CF with substantial interest coverage). Furthermore, the company's Entice wells provide a healthy rate of return even at today's oil prices, and should be impressive now that expense reductions and economies of scale are kicking in.

The difference between the stock price and the underlying value is now bizarrely wide. Our estimated fair market value (FMV) is around $3 per share today, and much higher assuming higher energy prices. At $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 at a reasonable valuation of 5x cash flow would justify a share price many times today's level.

As we stated above, St Andrew and Manitok, trading at less than 2x (ex-cash) and 1.5x cash flow respectively, are the cheapest, healthy, growing companies in their sectors that we can find.

Our top holdings in our All Cap portfolios also include positions in large caps *China Unicom, Volkswagen, KKR* 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 added new positions in *MetLife, Bank of Nova Scotia, Google, National Bank, AIG, Samsung* and *Hitachi*—all summarized in our Global Insight portfolio review below.

Global Insight (Large Cap) Portfolios – Key Holdings

To date, our Global Insight Long/Short Model (our entirely large cap model) is up 6% (USD) and 14% (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 FMV estimates 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 performed as expected. The realized gains on our "longs" have been above 20% annualized. The overall performance has been inhibited by risk management tools (cash, shorts, puts) and unrealized losses from resource companies.

China Unicom, one of 3 dominant competitors in the Chinese mobile telecom market, is closing in on our fair value estimate. However, considerable upside could remain given China's low penetration of cellular data usage. Additionally, near term catalysts include: 4G rollout this year, lower handset subsidy costs, lower selling/marketing expenses and clarity on the pending cell tower joint venture with China Mobile and China Telecom. As costs continue to fall and revenues continue to grow, we remain confident in China Unicom's long-term free cash flow outlook.

Fiat Chrysler was the best performing major auto stock in '14 driven by the Chrysler acquisition, aggressive new near-term targets and an improved balance sheet. Lower gas prices have improved investor sentiment and pending new product launches should help increase operating margins. Over the next few years the company plans on refinancing Chrysler's debt which could save the consolidated company €1B annually. We are unwavering supporters of Fiat's CEO Sergio Marchionne and applaud the strategic decisions he continues to make. The pending spin off of Ferrari could add some visibility for the company. Fiat is approaching our estimate of fair value, which is just above $17.

KKR, the private equity firm with nearly $100 billion of assets under management and a proven 40-year track record, suffered some unrealized investment losses during Q4, driven primarily by energy related investments. While disappointing, we see the current turmoil in the energy industry as an opportunity for KKR to acquire high quality assets trading at substantially less than fair market value. More importantly, the write down will not impact KKR's ongoing evolution away from concentrated private equity bets to a more diversified approach consisting of liquid public investments, income generating assets, and investment funds. Our valuation remains just over $30 per share.

Leucadia National trades at a 30% discount to our estimate of the sum-of-its-parts, which continues to grow. This conglomerate owns investment dealer Jeffries and a collection of other assets. The company's investment shrewdness was showcased recently. The embroiled currency brokerage FXCM that nearly failed due to the unpegging of the Swiss Franc accepted a $300 million loan from Leucadia. Reminiscent of past Berkshire Hathaway deals, FXCM was forced to accept terms that are highly favourable to Leucadia. It stands to receive a high yield, high fees and, most importantly, 70-80% of proceeds once FXCM or its components are sold—a requirement after three years should Leucadia demand it. Though this deal is not material to our appraisal value of the company, it does reinforce Leucadia's capital allocation skills which have been its hallmark since inception.

Allianz has marched towards our fair value estimate of €150 per share. Our original thesis was that Allianz's diverse platform would buffer any losses at its troubled PIMCO unit. This looks to be the case as the company continues to post solid results despite outflows at PIMCO hitting a record €47 billion during Q3. Since the position has moved closer to fair value, we will likely replace it shortly with a more undervalued holding.

Volkswagen's China sales continue to set records with nearly 1 million deliveries in Q4 alone. Premium brands Audi and Porsche continue to sell well globally. The weak spot continues to be the Volkswagen brand where profitability is lagging and the U.S. market position is challenged. Shares have increased substantially since the October lows but we still see upside. Our sum-of-the-parts valuation, which values each brand independently, is €250.

With gold bottoming around $1,140 per ounce and subsequently rebounding, shares of *Goldcorp* have followed suit. In 2014 the company produced a record 2.9 million ounces (up 11%). Costs decreased about 6% leaving all-in sustaining costs around $950 per ounce. Goldcorp is forecasting 20% production growth in '15, to between 3.3 and 3.6 million ounces, with commercial production achieved at Cerro Negro on January 1 and Eleonore commercial production expected in Q1 '15. Goldcorp continues to represent one of the best trade-offs between value and growth in the senior gold space with an FMV of approximately US$30.

Barclays was purchased when it dipped to 60% of book value despite the fact that the company is growing its non-investment banking operations nicely with ex-investment bank return on equity close to 15%. Barclays has recently recovered close to our FMV estimate of £2.80 and we will likely liquidate our position in the coming weeks and redeploy into a more compelling opportunity.

The oil price collapse has hit both E&P companies and oil services companies hard. However, Halliburton's bid for *Baker Hughes* (1.12 shares of HAL plus US$19 cash per share) remains in effect. The recent oil price rebound has allowed the share prices of both companies to recover and Baker Hughes is only a few dollars below its post-offer price levels. We continue to believe that the fair market value for the combined entity is higher than today's market price as cost cutting, equipment rationalization and a more complete product and service offering allows new Halliburton to compete more effectively against the market leader, Schlumberger. Halliburton, which we also own, should approach our estimated FMV of approximately $50, implying a slight discount to Baker Hughes' takeout price of $75.

We recently repurchased shares of *Google* after concerns about the health of its core search business pushed shares down. Competitive pressures continue to mount from Facebook, Apple, Amazon and new entrants. Revenue growth will also likely slow from the current high-teens run-rate over time. We felt these concerns are more than discounted in the share price. Our conservative valuation model—which aggressively fades revenue growth over the next five years and does not assume any of Google's various ventures amount to anything—yields a valuation in excess of $600. We were encouraged to hear on Google's most recent conference call a clear articulation of its capital expenditure approach and a strong commitment to building shareholder value.

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: Cablevision, Randgold, Hitachi (since repurchased after falling back to a floor) and Marathon Petroleum.

Credit Suisse Group was sold after it fell below a TRAC™ floor to avoid further potential declines from those levels, especially in light of the potential impact of the Swiss Franc revaluation.

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

MetLife has generated impressive earnings and a solid ROE despite the low interest rate environment. Though the share price has moved up over the last couple of years, its solid business performance has not impressed the market as evidenced by virtually no share price advancement over the last 5 years. Admittedly, we can't identify a clear catalyst that will attract investors in the near term. However, with interest rates at rock bottom lows and MetLife trading at less than 9x estimated '15 earnings, we cannot pass up the opportunity to own arguably the most diverse and best managed global insurance franchise. We may be early, but we see large upside should the interest rate environment normalize over the next few years. In the current interest rate environment we estimate FMV at around $60. Should interest rates slowly revert higher and MetLife's investment performance rise accordingly, value could quickly rise to $80.

We added *Samsung* during the quarter after shares fell to book value for just the third time in 7 years. Last year was challenging for Samsung with total revenues down nearly 10%. The IT & Mobile Communications division, which accounts for 54% of total revenues, was the primary driver behind this decline as it experienced a 20% revenue decline due to lower handset sales. 2015 should mark the low point for the Mobile division as the company streamlines its portfolio and refocuses its marketing efforts. Meanwhile, Samsung's Device Solutions division continues to be the star performer; we expect '15 revenue and operating income to rise 7% and 20%, respectively. Our estimated fair value is KRW1, 500,000 which translates to about US$750 per the internationally listed shares we hold, which equates to only about 11x estimated earnings.

With the crude oil sell-off causing fears of a Canada-wide slow down, led by the possibility of a sharp downturn in Alberta, we were able to buy new positions in the *Bank of Nova Scotia* and *National Bank*. We believe that the fears from the oil patch impact are overdone.

The Bank of Nova Scotia, Canada's most international bank, with operations in Latin America, the Caribbean and Asia, is currently trading at an attractive valuation despite generating a solid return on equity of nearly 16%. The bank's strong capital position allowed it to repurchase 4.5 million shares and hike the dividend twice in '14. We will closely monitor the bank's provisions for credit losses, as a key indicator of the health of the loan book and leading indicator of future profitability.

Similarly, National Bank, driven by its core Quebec market, traded down despite an ROE of about 18%. National is also well capitalized and recently bumped its quarterly dividend too—now a 4% yield. Here too, we'll watch the provisions for credit losses closely. Although loan loss provisions ticked up slightly in the most recent quarter and guidance indicates another few basis points of deterioration, we believe that management has taken appropriate risk provisions.

Gains for the Canadian financial sector may be more muted than in recent years; however, we believed that there was upside of perhaps at least 20%, plus sustainable dividends, which merited an investment in both of these Canadian chartered banks.

After buying and selling *Hitachi* last quarter, we recently bought a position in the stock again. The shares fell back to a floor and are attractively valued while the Yen is also at a floor in our TRAC™ work. We believe that there are now two potential sources of positive return expectations—capital appreciation and Yen appreciation. Hitachi is Japan's largest industrial-electronics manufacturer. The company has been aligning its portfolio of businesses to focus on social innovations, such as securing water, energy and food resources, replacing aging infrastructure, reducing pollution, improving transportation and improving the yield/efficiency of recycling. Recently it reported a solid quarter but failed to bump its guidance (which had been anticipated), and the shares declined sharply. Since nothing has changed with next year's outlook, we still believe the FMV is about 1,000 Yen or $84 per ADR.

Income Holdings

After recently falling to 1.64%, the 10-year U.S. government bond now yields 2%. Slower growth and disinflation continue to keep global rates low. We still 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 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 recently switched a couple of REIT positons. We eliminated our Calloway position after it lifted back to our estimate of FMV corresponding with a ceiling in our TRAC™ work. And we purchased *Artis REIT*. Artis has a diversified real estate portfolio at an implied 7% cap rate. Artis has a portfolio covering 25 million square feet across Western Canada (65% of net operating income), with the balance in the U.S. and Ontario and is reasonably diversified by type; office makes up about 52% of income, retail 24% and industrial 24%.

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); *Sun Product* bonds (a private company held only in our taxable accounts) has benefited from better earnings; *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; *JAKKS Pacific's* positive sentiment toward its strong product lineup should help narrow the spread in its bonds; *Student Transportation* shares trade at a slight undervaluation but could easily be the subject of a consolidation with a larger entity; *Retrocom REIT's* price still doesn't reflect the underlying net asset value which is growing from optimization of its real estate portfolio; *Brookfield Real Estate Services* continues to benefit from its steady royalties based on the increasing number of real estate agents in its network; *Telecom Systems* bonds growth continues with strong Q4 results where revenue and EBITDA were up 19% and 14% respectively; *Northwest REIT* bonds should benefit from the internalization of management which helps simplify its structure while allowing it to refocus on potential acquisitions.

Treading Carefully

Investors clearly need to proceed with caution and to be discriminating, by asset class and geographically. Clearly, government bonds offer minimal return and are risky if indeed central banks are successful in achieving an increase in inflation. Equities are superior. Energy stocks are cheap, but only if oil prices recover. European stocks may be cheaper than U.S. equities with the weaker Euro helping earnings too.

Some large blue chip companies are at extreme valuation levels that are unlikely to allow gains looking out over the next few years. While they may be terrifically-managed, growing companies, valuation levels are too far above that which can be justified by their underlying profits. Even more than usual, today one must very carefully select undervalued positions to ensure future potential returns.

Notwithstanding they were already cheap, our small caps, particularly the commodity producers, have suffered. We intend to continue to migrate to larger caps as the small caps recover to an equivalent undervaluation to our large cap prospects. The larger caps are preferable as their liquidity allows us to trade them when they rise to fair value or exit more readily if they decline through a TRAC™ floor. The average hold period for our big caps over the last 2.5 years is about 130 days. Because they tend to recover to fair value more rapidly, we expect to achieve long-term returns from large caps similar to those expected from small caps which typically are more undervalued but tend to require much longer hold periods. Though, as noted, our current small cap holdings are so undervalued that they merit our continued patience.

The global economy requires growth and some inflation. Yet, Germany wants austerity. Therefore, the conflict with over-indebted, recessionary, Greece. The U.S. is urging Germany and other European nations to engage in deficit spending and not just fiscal stimulus. Currency debasements and ultra-low interest rates are currently in vogue. The Fed, concerned with the high dollar, declining exports, deflation, and low wage growth, is moving slowly to raise rates, likely not until later in the year. Unusual times for sure. Difficult to predict outcomes. Time to keep all eyes on our top down tools as we continue to invest from the bottom up.

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