



## HALF FULL OR HALF EMPTY

The ultimate question for investors. Is the glass half full, that is to say are economic backdrops improving to support attractive valuations, or to the contrary, half empty, deteriorating and threatening full valuations?

In the half empty diagnosis, economic growth worldwide has generally been low—the worldwide outlook at about 3.5% for this year. The second largest economy, China, has been slowing, to what will still be an enviable 6-7%, now mainly from emphasis on domestic consumption as opposed to exports, and from a strengthening currency which it hopes can be part of the IMF reserve currency group.

The U.S. had negative Q1 growth, partly weather related, but also from a trade deficit at a 6-year high from the strong dollar causing weakness in exports. But the dollar appears to be peaking, which should help. On the other hand, U.S. mortgage rates have recently risen with the rise in bond rates, the 30-year fixed rate hitting 4%, okay for now, but could hurt housing affordability.

Many economic statistics are mixed—half full and half empty. U.S. unemployment recently dropped to 5.4%, the lowest since '08, and U.S. wage growth which had been stagnant seems to be accelerating. While corporate earnings are strong and mostly improving, relative growth has not kept up, the earnings helped by unusually, perhaps unsustainably, strong profit margins, and historically high productivity. S&P 500 earnings are expected to decline for the first half of this year, the first decline in 6 years, although mostly attributable to the drop in energy prices. The U.S. stock market, at all-time highs, appears fully valued at 18x forward earnings, supported by historically low interest rates and competitive dividends creating investor demand, and by share buybacks. But interest rates have been rising recently, and stimulation from a weakening dollar could allow the Fed to end its easing in another quarter or two. Indeed, Fed Reserve Chairwoman, Janet Yellen, just noted that equity prices are high and debt market investors are taking excessive risks, noting low differentials from yields of riskier corporate debt and safe-haven Treasury debt. A glass half empty caution from the head bartender. When the Fed will tighten is an important issue.

While U.S. federal deficits have been declining from spending cuts, a half full item, the debt level of \$17.7 trillion, doubling since the Crash and almost equalling GDP, is still unsettling—a half empty item, especially as interest rates rise. Of concern, worldwide government debt is about US\$58 trillion, a 76% increase since the end of '07, from huge public sector borrowing. Household debt in Canada is at an all-time high, a constraint on spending. Clearly a glass half empty. Again, especially as interest rates rise.

The global economy still appears to be lifting. And the U.S. is starting to recover from its earlier soft patch. Half full.

And while China is slowing, its economy is still growing relatively strongly and its stock market has been strong too. And to help, China just lowered its interest rates for the third time in 6 months, to stimulate the economy in the face of high corporate and government debt. Filling the glass.

India is also growing well too under its stronger leadership. The Eurozone, also helped by quantitative easing, is no longer flirting with recession and the IMF in April raised its Eurozone growth outlook to 1.5% for this year and 1.6% for next, driven by money supply growth, the ending of austerity, higher stock prices and surprisingly better growth in France and Italy. A glass half full. Greece still remains an empty glass. And regional Eurozone unemployment is high, in Spain, for example, at 24%.

### **Glass Filling**

All in all, despite markets currently being fully valued, likely requiring a modest correction, we believe the glass is half full. Though interest rates have risen slightly they should still stay relatively low and stimulative, especially as central banks struggle to avoid deflation. In that regard the commodity glass which was half empty, as commodity prices and especially oil prices were weak but economically stimulative, is starting to fill. And indeed, oil prices have made a significant recovery from their lows. Gold and silver seem poised to move up too.

U.S. home prices are rising, and that, and stock values, should encourage consumer spending, which accounts for about two-thirds of economic output in the U.S. And consumer confidence is rising. Household net worth per capita is at a record high. And U.S. new home sales are up. Unemployment should continue low. In all, U.S. economic growth should improve, albeit perhaps slowly. A glass filling.

Herb has often been called Mr. Glass Half Full. That's because we are almost always optimistic about our undervalued stocks. It normally pays to be so. Only in recessions/bear markets should one typically be bearish. That's the key reason we developed our macros pillars—TEC™ and TRIM™—our economic composite and market momentum indicator—to signal when the glass is emptying and that our undervalued positions may be facing strong head winds. Back in the early eighties Herb was also referred to as Mr. Bond, when his belief that interest rates at 14% were set to tumble as inflation was being quelled, pushing him to favour bonds over stocks. He was right then. Now he thinks U.S. 10-year bonds at 2.2% and the Canadian 10-year at 1.8% are in a bubble, and with no real return should be avoided. Our goal is not to consummately view the glass as half full but to go where the money will be treated the best and to attempt to protect our capital the best we can when the flowing ceases and the ebbing begins.

Otherwise, being optimistic most of the time tends to be beneficial. The market rises most of the time. And undervalued stocks tend to rise toward fair value. The probabilities during most periods are on the side of increasing values.

That being said, our small cap positions have once again been ensconced in a small cap resource bear market. One that had decoupled itself from the overall economy making the declines from 2011 difficult to predict. Though, this glass is now filling too. In our TRAC™ work, oil, gas, gold, silver and many other commodities have given buy signals. And as important, the individual company issues that have also held back many of our small cap positions have mostly gone away. We believe the glass for these companies may be overflowing as the potential triple whammy of higher commodity prices, growing production and a lift toward fair value all remain ahead. At the same time, the U.S. dollar index is at a ceiling and other currencies, including the Yen, the Euro and our Canadian dollar are at floors. Unless there's a global deflationary slowdown, which may result in an even higher U.S. dollar, we see a major inflection underway.

## **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 than smaller stocks, 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.

Our small cap holdings remain extremely undervalued primarily because they've been ignored, which we attribute to 4 consecutive down years of commodity prices (though, there's never been 5), stagnating growth or worse, company specific issues that caused investor concern. They have all had material changes though and their businesses are all growing or about to do so. 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 high. We elaborate on the key holdings below.

*Specialty Foods Group*, a shareholding in a private company held in our taxable accounts, is preparing to liquidate its assets through a wind-down. The company has placed \$40 million (of its more than \$50 million cash) in trust, earmarked for distribution. There is a remaining business line which is now performing well and is expected to be put up for sale. The approval of the wind-down plan, including the distribution of cash held in trust, requires Board approval and the complicated corporate organization structure needs to be unwound before the remaining proceeds can be distributed. We continue to expect a partial return of capital to stakeholders beginning in the next few months with the balance later in the year. In our view, there remains 10-30% upside to our current carrying value.

*Orca Exploration*, like our other small cap positions, is now undergoing significant improvements in its business. The Tanzanian government has been making strides in paying its obligations to Orca, thanks to the World Bank which has been providing aid to the government. TANESCO, the national power utility and Orca's primary customer, is meeting its current obligations to Orca and is making a dent in the arrears too. While Orca provides over 90% of the natural gas to Tanzania which generates over 50% of the country's power, we have been waiting for years for the new pipeline in the country to be built so that Orca could expand its production. It's now mostly built and commissioning is expected this summer. Now that corrupt government officials have been dealt with, we expect to hear imminently that the IFC (an arm of the World Bank), which proposed allocating \$60 million toward Orca's \$120 million expansion plans, has finalized its terms. This will pave the path to filling the new pipeline and limiting the brownouts in the country.

Orca's cash (it has no debt) and funds still owed by TANESCO amount to about 75% of the entire share price. With an estimated reserve value of over \$11 per share, the combined value is about 4 times the share price. Because the value is so high relative to the share price and the World Bank is now involved, downside appears minimal. We expect Orca to produce near record levels in the next 12 months. The company's long-life natural gas reserves, low operating costs and high netbacks should make the company of interest to potential suitors. Orca announced in the fall that it had received unsolicited expressions of interest in all or parts of Orca's assets; however, we believe the uncertainties in the country may have precluded anything from advancing to date.

*St Andrew Goldfields* is also making significant headway with its underlying business. Its most recent quarter showed solid cash earnings. And its newest mine, Taylor, has been given the go-ahead to move toward production which is expected by Q4. 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% last year which extends mine life. The Holt mine has performed well and Holloway has been delivering beyond expectations. Based on Q1 results, production is running just below the 100k ounce per year level. And guidance for next year is 125-135k ounces. The low Canadian dollar is helping margins too. Even at today's gold price St Andrew should deliver free cash flow in 2015 of over \$15 million and over twice that in 2016. With net cash in excess of \$26 million and only about \$107 million of EV (enterprise value—market cap plus cash less debt), the market continues to undervalue St Andrew—on many metrics the company is the cheapest in its sector. The net asset value of the company, at today's gold price, is more than \$0.60 per share, almost twice the current share price. If gold prices rise back to normal—at a reasonable premium to the average cost of production, in line with the marginal cost of production—upside should be even higher. Half the producers globally have all-in sustaining costs above today's low gold prices.

*Manitok Energy's* production has been stagnant around the 5,000 boepd level for several quarters. Though the company made significant discoveries, production delays occurred as a result of tie-in issues. The production glitches are nearly fixed—the Entice wells, which have been above expectations, encountered facility limitations but these should be alleviated shortly. More importantly, the Entice discoveries gave rise to several new oil pools but the new wells have not been on line long enough to offset the impact from declining energy prices. Furthermore, the company recently announced a major acquisition of land, including 1,800 boepd of production, in the Wayne area, near Entice, and acquired the other half of the checkerboard sections at Entice (adding the other half not already held)—all from PrairieSky Royalty. Manitok was also able to renegotiate its arrangement on the freehold land it leases from PrairieSky whereby the royalty rate was lowered to a flat 17.5% (particularly notable now, in light of the newly elected NDP government in Alberta which may increase rates on crown land). The drilling timelines were extended too, eliminating concerns that previous terms may have proved onerous for Manitok's balance sheet if energy prices were to remain low.

Our estimate of the value of Manitok today is above \$2.50 per share, more than double the share price. Our previous valuation estimate of over \$4 is still achievable with higher oil and gas prices. The company's debt should be a manageable \$65 million in Q2 and has been assisted by oil and gas price hedges and limited capital spending for the first half of 2015. Other than production glitches, the key risk for Manitok has always been the decline in oil prices. That risk appears to have diminished with the severe oil price decline from last summer. Like gold prices, oil prices trade around the average cost of production for the industry, and with the number of drilling rigs having plummeted in the U.S. it's unlikely that oil prices would remain low. Oil supplies have begun to flatline while ever-growing demand could create a supply-demand deficit later this year. Even at today's oil prices Manitok should generate very high IRRs (internal rates of return) on their drilling at Entice and Wayne. Looking ahead, cash flows should ramp for several years from the company's now high inventory of drilling locations and justify a share price many times today's level. With all its attributes, it's unwarranted that Manitok trades at valuation multiples well below its peers.

*Dynacor* has been waiting for approval for its larger mill which took much longer than expected because the government was busy enforcing the rules against small noncompliant miners and millers. However, the approval was recently finally granted and construction is beginning. The new mill should be completed in less than 9 months, allowing earnings power to climb to over \$0.40 per share annually from \$0.30—which the current mill expansion should allow it to earn, starting in a couple of months. The company is a miller of gold, not a miner, which leaves it much less susceptible to bullion price movements. *Dynacor's* own exploration properties could add substantially to the value of the company. It is spending \$6 million this year to advance its Tumipampa project, mostly on the areas it considers to be development work since the grades have averaged over 20 g/t, nicely above that required for having its own viable mine. An NI 43-101 report delineating an initial resource, likely in excess of 1 million ounces, is expected around year end. Some of the intercepts have been outstanding, with as much as 111 g/t discovered. We anticipate serious interest from other majors in the area in *Dynacor's* potential mine(s).

*Dynacor* has no debt and about US\$15 million of cash, much of which will be used to build the new mill. Net of the cash, its stock trades at only 5x its expected run rate of annual earnings once the existing mill is expanded shortly. At just 10x those earnings, this could double the share price, without the added volume from the new mill or any potential value from Tumipampa.

*Pivot Technology Group* catapulted up in the last few months after announcing a dividend on the common shares and a conversion of the preferred shares to common shares. Its earnings report showed continued growth and the company has received public recommendations by an analyst and a portfolio manager which pushed up the share price. We took this opportunity to lighten up on our position, especially since it became disproportionately high as the company traded closer to our view of FMV (fair market value), though potential upside remains.

*Corridor Resources* is the position that may take the longest time for its glass to fill. That said, it should see advances in its business over the next 12 months. Potential upside will be dependent on the New Brunswick Liberal party's temporary ban on fracking being resolved. There is some possibility it may be lifted within a year. It is unlikely that the ban would be permanent since New Brunswick's gas resource is immense and far too meaningful to the downtrodden province. *Corridor's* fields are far from populated areas and fracking is at depths that do not impact the water table. Potash Corp. is a large employer in the province and dependent on *Corridor's* main gas field. Repsol has submitted a plan for a Saint John LNG export terminal. This would be the largest project in the history of the province and it's hard to believe the government would not back it. And *Corridor's* gas would likely be needed to make the facility a success. *Corridor* still needs a partner to prove up its Frederick Brook resource, which will be difficult until the fracking moratorium is lifted.

Recent stratigraphic cores at Anticosti Island, Quebec, assisted the third party engineers to boost the estimated shale oil resource by around 50% to over 30 billion gross barrels of oil in place. The Quebec government and Maurel & Prom, a mid-tier international oil company, are spending up to \$100 million drilling on Anticosti Island. Wells will be drilled in 2016 which could bring this project to the fore. *Corridor* is also seeking a partner for its Gulf of St. Lawrence Old Harry project, which has significant potential upside, but much more work needs to be done to ascertain its viability.

Meanwhile Corridor trades at half of its Net Asset Value, and the company has projected \$27 million of working capital (and no debt) for the end of 2015—nearly half its share price. The New England market, where Corridor sends its current production, is still undersupplied. The premium the company receives for its gas should be about \$3 per mcf over prevailing gas prices for some years to come. The company has a sufficient cash balance and cash flow to carry on until the megaprojects kick in. And we continue to believe that the upside potential ought to be worth the wait.

We continue to hold shares of *Honda Motor*. The company has seen its margins come under pressure over the last few years. This would typically speak to a sick business or intensifying competitive pressures. However, in Honda's case, current margin pressure is a result of heavy investment in new products and growth initiatives. Quality control and recalls have also impacted results. With the heavy investments and quality control issues in the rearview mirror, we see potential for a clear pathway for higher margins and top line growth. Our fair value estimate for Honda is approximately ¥4,800 which equates to 1.3x book value.

Our top holdings in our All Cap portfolios also include other positions in large caps *Triumph Group* and *KKR* which are discussed below in our Global Insight portfolio review.

### **Our All Cap Portfolios – Portfolio Changes**

In the last few months we added new positions in *Hewlett-Packard*, *IBM*, *Owens Illinois*, and *Qualcomm*—all summarized in our Global Insight portfolio review below. We sold China Unicom and Volkswagen as they had risen close to our fair value estimates and Abercrombie & Fitch after it declined through a TRAC™ floor.

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

Through April 30, our Global Insight Long/Short Model (our entirely large cap model) is up 7% (USD) and 13% (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.

*Fiat Chrysler Automobiles* continues to trade at a discount to our \$18 per share appraisal value while the company recently posted results ahead of our expectations. However, the shares sold off slightly as the company failed to produce operating leverage and reported higher debt than expected. We continue to favour Fiat's executive team and found several bright spots in the most recent quarter. Notably, the company reported a 6.5% automobile market share vs. 6.2% one year ago and Fiat continues to narrow the profitability gap versus Ford and GM in the key U.S. market. We are confident the combined Fiat/Chrysler will reduce debt and lower interest expenses by 2016 while continuing to execute on its operational plan. Meanwhile, we continue to applaud Fiat's CEO Sergio Marchionne's outspoken strategic decisions regarding the company and overall industry.

Investors cheered specialty chemical company *Celanese's* first quarter results. Shares now trade at an all-time high, close to our estimated \$75 fair value. We expect to sell the position shortly and redeploy sale proceeds into a more compelling opportunity.

*Triumph Group*, an aerospace parts and systems manufacturer, had been suffering from cost overruns on some of its key platforms but these issues appear to be behind them now. Earnings revisions have steadied and are lifting again as acquisitions have driven sales growth. The company has been looking to hire a new CEO after it recently temporarily replaced the former CEO with the original founder. We expect increased restructuring efforts to enhance productivity across the company's many facilities. Our FMV estimate is in the low \$80s.

*KKR*, the private equity firm with around \$100 billion of assets under management and a proven 40-year track record, has begun to run up toward our FMV estimate. The dividend yield remains very attractive at 8.5%. We continue to see plenty of opportunities for the company to invest capital, especially in the depressed energy space. Our valuation remains just over \$30 per share.

*IBM* is a new position. Its CEO, Ginny Rometty, pushed the reset button by abandoning the 2015 \$20 EPS goal set by former CEO Sam Palmisano. We view this move as positive as it gives the company much needed flexibility to reignite growth in the new data and cloud-driven technology landscape. IBM has a long history of executing bold transformations; evidence of a turnaround is emerging as new growth areas such as analytics, cloud, mobile and security recorded 20% year-over-year revenue growth in Q1. Trading at merely 10x 2016 estimated EPS, the current share price has not embedded future growth expectations. Our FMV estimate is \$200 per share.

We continue to hold IBM's German peer, *SAP*, as well, although the share price has ascended close to our estimated fair value so we will likely be liquidating the position in the near future.

*Bank of Nova Scotia's* stock price has treaded water over the last six months as investors struggle to make sense of a confluence of factors such as falling oil prices, falling Canadian interest rates, what appears to be an overheated Canadian housing market, and rising credit risks in Mexico and Peru—BNS is Canada's most international bank. We believe that BNS is the best positioned of the Big Six Canadian banks with its combination of strong balance sheet (BNS' Basel III gross leverage ratio exceeds all of its Canadian peers) and international growth opportunities. On the housing front BNS has the lowest exposure to unsecured Canadian household credit. Our estimated fair value for its shares is \$80.

*National Bank* has fared better, bouncing off its recent bottom which we believe was mostly influenced by the fears from potential loan losses in the oil patch. National Bank, driven by its core Quebec market, has an ROE of about 18% and is well capitalized. We will watch the provisions for credit losses closely, though we believe that management has taken appropriate risk provisions. Gains for the Canadian financial sector are unlikely to be as robust as in recent years; however, at 20% discounts to our FMV estimates, plus relatively high sustainable dividends, both BNS and NA appear attractive to us.

*Barclays* has performed reasonably well in British Pounds since our purchase and lifted close to our FMV of £2.80 though the strength of the U.S. dollar has somewhat restrained the share price rise in USD terms. We will likely liquidate our position in the coming weeks and redeploy into a better opportunity, especially since we are finding more compelling opportunities in the financial sector where we are already pushing our own sector guideline limits.

With the common shares still trading at 20% below its growing sum-of-its-parts we continue to hold *Leucadia National*—a conglomerate that owns investment dealer Jeffries and a collection of other assets. The company released Q1 results which reinforced our bullishness. Specifically, Leucadia reaped significant rewards from its emergency lifeline to currency broker FXCM as the investment has tripled in value in just the last 3 months. As we noted last quarter, though the deal was not material to our appraisal value of the overall company, it reinforces Leucadia's capital allocation skills which have been its hallmark since inception. Additionally, the company noted that the near-term weakness in the key Jeffries segment appears to be passing which should allow the investment sentiment to shift in the company's favour.

### **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: China Unicom, Volkswagen, Allianz and Haliburton.

Abercrombie & Fitch was sold after it fell below a TRAC™ floor to avoid further potential declines from those levels.

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

*Hewlett-Packard* came to our attention after its stock fell more than 15% on the heels of poor Q1 results. HP is in the middle of splitting itself into two separate companies that will serve different end markets. HP Inc. will house the personal systems and printing units while Hewlett-Packard Enterprise will focus on technology infrastructure, software and services. While a costly endeavour (the final bill should come in at around \$2 billion), we believe the separation has merit. HP has been slow to respond to the fast moving changes in the retail and enterprise markets; two highly focused and flexible organizations will be able to compete more effectively. Our sum-of-the-parts valuation is \$41 per share.

We repurchased *Qualcomm* after its shares declined to the same valuation discount as when we last purchased shares in 2013. Qualcomm's valuation and recent poor operating performance has captured the attention of activist investor Jana Partners. Jana has lobbied Qualcomm's management to institute aggressive share buybacks and heightened cost management. These talks, no doubt, led to Qualcomm's recently announced accelerated stock buyback program that could see \$5 billion worth of stock repurchased. More controversially, Jana has argued for a spin out of Qualcomm's chip business. Our base case value is \$80 per share, with upside should Qualcomm significantly reduce operating expenses or unlock shareholder value via a spinoff or further share buybacks.

*Owens-Illinois*, the world's leading glass container manufacturer, has been on our radar screen for quite some time, but management missteps and macro headwinds in its key European markets had kept us on the sidelines. This quarter we finally pulled the trigger as we felt the stock price—at \$23—discounted many of our concerns. Furthermore, we started to see some clarity on many of the issues facing the company. North American supply chain problems appear to be sorted out. European results should benefit from a better macro environment and lower bottling capacity. Long awaited industry consolidation—which would curtail overcapacity—could be sparked by Owens-Illinois' recent acquisition of Vitro. Our target is \$30 per share but could be ratcheted significantly higher should industry conditions improve. Imagine, a glass manufacturer that benefits from the half full and half empty demand.

## **Income Holdings**

After recently falling as low as 1.64% a few months ago the 10-year U.S. government bond now yields 2.2%. Slower growth and disinflation have kept rates low around the world. Higher rates though are likely coming. After lifting toward 7%, high-yield corporate bond rates have settled in at just over 6%. Our income holdings have an average current annual yield (income we receive as a percent of current market value) of over 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 one REIT position for two others. We eliminated our Retrocom position because its turnaround has taken longer than we had expected. We purchased *Morguard REIT* which has a diversified real estate portfolio of 49 retail, office and mixed-use properties in Central and Western Canada. It pays a 5.6% yield but their balance sheet is under-levered allowing for future growth. Property enhancements and acquisitions should help narrow the historically wide discount to its net asset value. And we added units of *NorthWest Healthcare Properties REIT* now that they are merging with NorthWest International Healthcare Properties REIT. Combined they own 99 medical office buildings and 23 hospitals that are 94% occupied in Canada, Brazil, Germany and Australia/New Zealand. Its tenants range across the medical and healthcare profession. The merger caused the unit price to weaken and created an opportunity to acquire REIT units at a discount to our appraised fair market value. The merged entity should produce accelerated growth fueled by international expansion. At a 9% yield the units offer an attractive current yield while investors warm to the new combined entity.

We eliminated our holdings in Allied Nevada as the company had been unable to effectively grow its business and appears to be in need of substantial additional capital to do so. Our position in Pivot Technology preferred shares was also sold from our income accounts after all of the preferreds were converted to common shares. Though the common shares will carry a reasonable dividend, the share price rose to a level that was closer to our estimate of fair value and no longer had the same risk profile for an income holding.

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; *JAKKS Pacific*'s positive sentiment toward its strong product lineup has helped narrow the spread in its bonds; *Ruby Tuesday*'s operations have begun to recover while its bonds are well covered by underlying real estate; *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* reported strong Q4 results which continue to enhance the credit quality of the bonds; *Student Transportation* shares trade at a reasonable discount to our estimate of its asset value; *Dream Office REIT* results have been ahead of expectations driven by favourable rent spreads though partially offset by marginally lower occupancy; *Northwest International Healthcare Properties REIT* bonds have benefited from the REIT's stable income stream and the company is now merging with Northwest Healthcare Properties REIT providing even more stable coverage.

### **Glass Half Full**

As value investors we continuously seek 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.

Even more than usual, it's time to be discriminating, by asset class and geographically. Government bonds offer little returns, in Europe some even turned negative, and bonds globally may prove highly risky once the central banks achieve their goal of boosting inflation. Equities are superior. Foreign stocks are cheaper than U.S. equities, likely providing higher upside, potentially from their rising currencies too.

Because investors have sought safety and yield, some large companies are at high valuation levels that are unlikely to allow for gains over the next few years. While these may be blue-chip companies, valuation levels are not justified by their reasonably expected earnings. We continue to carefully select undervalued positions to help ensure future potential returns.

We keep migrating to larger caps and now hold about 24 large cap positions in most all-cap accounts. As the small caps recover to an equivalent undervaluation to our large cap prospects, we intend to continue to reduce our small cap exposure. 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 TRACT™ floor. The average hold period for our big caps over the last 3 years is just under 140 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, our current small cap holdings are so undervalued that they still merit our patience until they too recover toward fair value.

We believe, from our work and others we follow, that a recession in the near term is unlikely, that central banks will continue to be stimulative keeping interest rates relatively low, that deflation risks will diminish, that worldwide economic growth should slowly continue and likely accelerate. And that equities will continue to be the preferred asset class, with bonds presenting a risky alternative. Ultimately the Fed will raise rates but it's probably being discounted as, likely, is the risk of deflation. Clearly stocks remain a glass half full, but their expected returns are lower than the last 5 years because of their already full valuations. Canadian small caps have been for some time, and still remain, incredibly undervalued—a shot glass half full. Certain sectors—energy, materials and financials—are cheaper, from the headwinds they have faced. Naturally, as value investors, we obviously are driven to cheap stocks currently out of favour.

The pundits seem to be divided. One man's half full is another's half empty.

Herbert Abramson and  
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May 28, 2015

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