TRAPEZE
ASSET MANAGEMENT

# TRICKY TIMES

Crosscurrents abound. For instance, stock markets were not expensive yet markets around the world have endured major corrections. And, though global growth is still moving up-and-to-the-right, some markets have had bear market size corrections, not the usual shallower bull market ones.

## Correcting From Fair Market

Valuations were not and are not extreme. The cap-weighted S&P 500, for example, still trades close to its fair market value (FMV) while the overall markets, on an equally-weighted basis, i.e., giving more credit to the average stock, are reasonably attractive at around a 20% discount to our estimate of FMV. The most likely explanation for the overall market correction is that markets around the world had achieved fair value and then market psychology turned rather negative from lots of negative news. Individual stocks and overall markets tend to vacillate between undervaluation and being fairly valued. Over time, as fair values rise so do share prices. Typically, once fair value is reached, a stock or market will decline because the upside potential is limited and/or risks are elevated. Only rarely will stock markets trade materially higher than fair value as observed in the '99/'00 bubble.

In a recession, business volumes retract which leads to declining earnings and falling business values. Some overleveraged enterprises face default which creates a daisy chain through the financial system. This leads to a bear market where quite often the market overshoots to the downside as investors over-extrapolate the declines in fair values. In a mere bull market correction, FMVs are still typically rising but investors flee the market as psychology creates an excess of sellers over buyers. Typically, once a sufficient correction takes place—at worst just about 20% from FMV (around the magnitude of a drop from a TRAC™ ceiling to a floor in our work)—then buyers begin to overwhelm sellers and stocks once again revert to fair value. If the headlines are rosy, markets can sometimes hang around fair value for a while but become vulnerable to corrections when grey clouds appear. And, as values are ever-increasing during these periods, corrections tend to only be of the shallow bull market kind.

More recently, the markets have been concerned with the slow pace of growth, the potential for a recession, deflating commodities, weakening profits, a Chinese slowdown and credit issues, bloated government debts, negative interest rates and global political tensions. These concerns, obviously, still overhang today's market outlook.

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## Repression Not Recession

There appear to be no signs of an imminent U.S. recession. The typical precursors to a recession are not there—oil isn't spiking (that's an understatement), unemployment isn't rising, bank loss ratios are stable, and the yield curve is not inverted. Our own Economic Composite (TEC™), designed to alert us to recessions in various regions around the world, is not forecasting a peak in the business cycle. Therefore, we do not believe that the markets' corrections should be as severe as the ones witnessed starting in '00 and '07 which were accompanied by recessions. Though a few countries around the world have fallen into recession, and concerns about China and elsewhere are prevalent, no prior U.S. recession has been precipitated by a foreign downturn.

Repression, however, is in full force. Governments around the world are pursuing financial repression, keeping interest rates below the inflation rate (negative real rates) which is a burden on savers but a boon to borrowers and is designed to spur lending. Many central banks have now even lowered rates to below zero, i.e., negative nominal rates. These governments are doing whatever it takes in an attempt to spur the velocity of money, the speed at which funds circulate through the system, in order to drive economic activity—though having provided the money, it just hasn't been flowing through the system fast enough.

In North America, interest rates remain extraordinarily low with the 10-Year U.S. Treasury hitting 1.5% recently. That's helping the U.S. housing and auto markets where sales remain robust. And unemployment is at multi-year lows and holding steady—normally a sign of continued growth.

While the rate of global GDP growth appears to be in secular decline, the IMF just projected growth for this year at a still reasonable 2.8%.

## What Do Falling Stock Prices Mean?

Stock markets decline for essentially one of three reasons. Either they're adjusting from an overbought level—usually a short, shallow correction, or they're correcting significantly because the level of fear is heightened (here too, the correction is normally short term) or a downturn in the business cycle leads to a corresponding decline in corporate values which leads to a bear market—a prolonged and severe decline.

Therefore, distinguishing the nature of the decline is critical. We generally do not concern ourselves unduly with bull market corrections. They tend to occur without warning and end abruptly. On the other hand, we are constantly on watch for a potential recession to alert us to a bear market. During a recession, it's not unusual for the market to fall in excess of 40%. That's why we designed TEC™. Historically, TEC™ flashes an alert, then it's followed by a TRIM™ alert a few months to a year or so later—our second level of warning to invest defensively.

Today, we are seeing something somewhat unusual. Though our TEC™ has not warned, our TRIM™ indicator has alerted us in 28 of 30 developed markets—the most recent being the S&P 500 in late January. Our read of the situation is that we are likely to have a larger than normal correction but not a prolonged bear market. The S&P 500 dividend yield is 2.3% and its earnings yield about 6.1%, much higher than the 10-year Treasury yield of 1.8%, clearly favouring stocks over bonds.

Our TRAC™ signal has warned too, with the Dow and S&P having given sell signals. And, many individual stocks remain "on sell"—having declined from ceilings on their way to the next floors. We sold many of our large cap positions as individual companies gave TRAC™ sell signals, meaning they portend lower prices as the shares fall to their next floors.

These sell signals are counterbalanced with the fact that there have only been 4 instances in the post WWII era that a bear market (more than 20% decline) occurred without a recession—1962, 1966, 1987, 1998. The evidence, thus far, is that we'll be adding 2015/16 to this list as the Russell 2000 fell 27% from its 2015 high to its recent low, as did the Value Line falling 28%. The Dow and S&P 500 may not be far behind.

**Our Strategy**

While FMV dictates the ultimate direction of the stock market, the path can be altered by psychology in the shorter term. We have been wrestling with heading for the hills, i.e., selling and holding few stocks, then buying the cheap stocks as they fall to bargain price levels. Every day can feel like either Black Friday or Boxing Day but we restrain ourselves because our tools indicate that even better bargain price levels may lie ahead as the macro concerns overwhelm. Just look at the correlation statistics between markets and certain commodities like oil. It's rare that the various markets around the world move in such a lock-step manner.

While we do not believe we are about to enter a recession, corporate profits have been declining from their peak. We are watching this carefully too. Earnings have been rolling over, or at best flatlining, so far mostly from the decline in energy prices impacting oil company earnings. Our preference is to remain defensive. But, as is always tricky, sentiment ebbs and flows. And, recently, bearish sentiment was at an extreme level which precipitated the recent market rebound. The stocks that rallied the most were the ones with the highest short interests, begging the question of the quality of the rebound.

That said, we are still interested in buying shares of solid companies at wide discounts from fair value, assuming their earnings outlooks are positive and particularly where we can find ones with immediate potential positive catalysts. When the market gets this oversold it typically rallies or at least stays flat for a couple of months. But, the state of the U.S. stock market, over the medium term, is susceptible to further declines. Since the early '70s, when the 50-day average is below the 200-day average, while the market is below its 10-week and 40-week averages, the market has declined at about negative 5% annualized—this state of downtrend has occurred about 17% of the time or about 7 years cumulatively.

On a positive note, gold has inflected from a low point, industrial commodity prices appear to have bottomed, and oil prices, now well below the cost of production, should begin to rise again in a couple months when the historic inventory overhang starts to decline.

This might mean that growth is about to accelerate. Or, to add another crosscurrent, that we may be headed for a period of stagflation. With unemployment low, wage pressures should begin to build. And, we are witnessing signs of inflationary pressures elsewhere, particularly in food prices. The latest figures in the U.S. showed 1.4% inflation while Canada's rate was 2%.

The strong U.S. dollar has restrained U.S. inflation but that too could turn. Conversely, the Canadian dollar has overcorrected, and is now back on buy in our work, likely headed back toward its purchasing power parity level—above $0.80—particularly when oil prices normalize.

Gold, oil, copper and other commodities have fallen to or below their respective global average all-in costs of production. This unduly impacted the resource heavy Canadian stock markets. The TSX fell by 26% from its September 2014 high to its late January low. And the junior stocks have been crushed, with the S&P/TSX Venture Index just having bounced from an all-time low. There are certainly bargains to be had here.

**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.

Notwithstanding the depressed (an understatement) small cap market, our small cap holdings have begun to move back toward fair value. The rally in gold prices has certainly helped. But, most of our small stocks simply just got too undervalued. Canamax Energy was taken private at a significant premium to its trading price. St Andrew Goldfields was acquired by Kirkland Lake Gold in an all share exchange. And, the recent rise in gold price, along with the decline in the Canadian dollar, has pushed the CAD gold price to a multi-year high. The value of Kirkland is now about 3x the value of St Andrew (on a comparable basis) versus this time last year. Dynacor has jumped too with the price of gold, its healthy production levels and its exploration success. Orca has also lifted recently as it has announced that management may be considering a privatization.

Meanwhile, most of our small company holdings still trade well below our estimate of their respective FMVs. 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 these key holdings below.

*Specialty Foods Group*, a shareholding in a private company held in our taxable accounts, has been preparing to liquidate its assets through a wind-down. The company has placed $45 million (of its more than $55 million cash) in trust, earmarked to be distributed to stakeholders. It has a remaining business line which just completed a record year. The approval of the wind-down plan, including the distribution of cash held in trust and the sale of the remaining business and distribution of its proceeds, requires Board approval and the complicated corporate organization structure needs to be unwound. We continue to expect a partial return of capital from the existing cash in the next few months with further distributions thereafter, though the timing and amounts of these payouts remain uncertain. Our carrying value, which is based on a third party valuation, once again increased meaningfully as at December 31 and, in our view, there still remains upside to our carrying value, mostly dependent on the sale value of the remaining business.

*Kirkland Lake Gold*, as noted above, recently bought St Andrew in a share exchange. The deal was done at a 46% premium to both companies' 20-day volume-weighted average price. We believe Kirkland was also undervalued, and there remains healthy upside in the combined company. Kirkland is amongst the highest grade gold miners in the world. The new company should produce around 300,000 ounces this year, making it an intermediate producer. At the current Canadian dollar gold price, we expect the company to deliver significant free cash flow which should allow more spending on the overall land package. The combined company is worth above $8 and we expect the gold price to move considerably higher in the months ahead—gold should trade above $1350, at a reasonable premium to the industry all-in average cost of production, in line with the marginal cost of production—which provides additional upside. Moreover, any material addition to resources and reserves would also be additive.

*ProShares Short S&P 500* is about a 10% weighting in most 100% Growth mandate accounts. This is a long position in an ETF which mirrors the inverse performance of the S&P 500 (i.e., if the market declines the value of this position increases) on a daily basis. Therefore, it's a simple way of hedging the U.S. market, for reasons detailed above.

*Orca Exploration* recently announced that David Lyons, its CEO and controlling shareholder, may propose a privatization transaction. Unless such a transaction represents fair value, we are not interested in supporting it. We believe Orca has considerably more value than is suggested by its share price—clearly so does David Lyons. Meanwhile, the company has recently successfully completed the workover of 3 wells and drilled 1 new well along with additions to the infrastructure. The revised total cost is projected to be US$80 million, down from the original estimate of US$120 million. This should lift production capabilities to in excess of 185 mmcf/d. To complete the work, the company drew down all of the US$60 million loan arranged last year with the IFC (an arm of the World Bank).

A lift in Orca's production should follow over the next 12 months. The country's new pipeline is operational and Orca provides nearly all of the natural gas to the country. It's unlikely that hydroelectricity will be a competing source of power since the country endures droughts and agricultural requirements are high. New power plants coming online, powered by natural gas, will materially boost demand in the region too.

TANESCO, the national power utility and Orca's primary customer, should continue to meet its current obligations to Orca. We also expect Orca to receive all its arrears. The World Bank has been providing aid to the government which should help too. Orca's net cash and funds still owed by TANESCO, net of payables, are substantial. With an estimated reserve value of over $11 per share, the combined value is about 4 times the share price. Finally, we believe the new government will work much more quickly to bring Orca's needed gas to market. We have patiently awaited these pieces to all fall into place and would not like to see the company privatized at this stage.

*Dynacor Gold Mines* has rebounded as the price of gold has lifted. Output hit just shy of 68,000 oz. for '15 with December's production achieving an all-time monthly record high. The new mill is expected to be completed shortly and could be commissioned by the end of Q2—this should lift earnings power significantly. As a miller of gold, not yet a miner, Dynacor is less susceptible to bullion price movements; however, the lower gold price has reduced industry production and the existing mill is a multi-hour drive through the mountains for most ore suppliers. The new mill, which is located on the main highway, should be more accessible to suppliers and should lower costs as well. Should the gold price continue to firm up, there's a possibility of filling both mills. The results from Tumipampa, the company's own exploration properties have been excellent, supporting Dynacor having a viable mine or creating value from the joint venturing or outright sale of these properties. An NI 43-101 report delineating an initial resource is still expected in the first half of '16. We anticipate serious interest from other majors in the area in Dynacor's potential mine(s). Our view of the FMV is over double the share price, without any potential value from the exploration property.

Most of the oil producers and gold producers globally have all-in sustaining costs above today's low oil and gold prices. Normally, these commodities trade at a 30-40% premium to the industries' average all-in costs. Although we've witnessed prices below industry costs in the past, it's usually during periods of great economic dislocation and, even still, those periods are short-lived—typically lasting only several months.

*Manitok* moved back into our top 10 holdings with our purchase of its secondary issue just prior to year end. After initially taking a harder line, the National Bank agreed to have the company pay down a smaller portion of its debt with the proceeds from an equity issue. While the equity dilution was substantial, we were able to lower our cost by participating in the issue. Our estimate of the net asset value remains well above the heavily depressed share price. The company's wells should be highly profitable even at low oil prices. And, the company now has about 300 drilling locations which should provide for years of growth. At a normalized price for oil, where prices move back above the average cost of production, Manitok is worth over 3x its current share price. And, with the expected drilling success, the company could generate a value, in about 3 years, in line with its former share price highs, even after the recent significant share dilution.

*Corridor Resources* doesn't trade for much more than its net cash value. Investors have not been prepared to associate any value to the company's business and potential forthcoming projects. We still expect the temporary moratorium for fracking, in place in New Brunswick since the current provincial government arrived in late '14, to be lifted soon. Industry studies continue to be positive toward fracking. Meanwhile, the Anticosti Island, QC, project has been threatened by comments made by the Quebec government—even though the key partner, they're now suddenly concerned about the environmental impact of such a project. Core results so far have been excellent and the first actual wells were expected to be drilled this summer. We would surmise that any dissolution of the agreement would require a material sum paid to Corridor and the other partners. The current operations from the McCully Field alone, along with the company's net cash balance, justify a substantially higher value, without the highly prospective Frederick Brook, Anticosti and Old Harry projects.

*Enerdynamic Hybrid Technologies (EHT)* is an income position—a secured debenture. The bond yields 18% and matures mid '17. EHT is a manufacturer of prefab structures whose buildings can also be outfitted with the company's solar and wind systems. While the company missed its first interest payment in December, which has been waived until mid March (in exchange for an extra 1% interest), the company is still expected to generate substantial profits over the next 12 months and should win additional contracts for schools, housing, health care centers and military shelters from various jurisdictions around the world. Contract wins have been delayed but the company has announced a major contract win in Africa last summer and Sweden more recently. The company will likely tender for all of its debt in the next few months, though noteholders won't have to relinquish the notes until after June 30. The debenture's healthy coupon attracted us along with the security feature—the company's $23 million in total debt is well covered by the value of its existing contracts, plant and equipment and contracts that are expected to be signed shortly.

Our top holdings in our All Cap portfolios also include large caps *Hershey Foods* and *Berkshire Hathaway* which are discussed below in our Global Insight portfolio review.

**Our All Cap Portfolios – Portfolio Changes**

In the last few months we added only one new position, *NetApp*—summarized in our Global Insight portfolio review below. We sold some Kirkland Lake Gold merely to reduce the position where accounts were overweighted, sold Canamax Energy after the takeover announcement, and sold Jacobs Engineering Group, Softbank, Goldman Sachs, Bed Bath & Beyond, Ford, CST Brands and American Express as all triggered sell signals falling below their respective floors or inflecting down from ceilings.

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

Through December 31, our Global Insight Long/Short composite (our large cap portfolios) is up 1% (USD) and 9% (CAD) annualized since inception June 1, 2012, net of all fees. A complete description of the Global Insight Model is available on our website. Our target for our large 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 well. The gains on our "longs" have annualized at 8% in USD and 17% in CAD. The overall performance has suffered from risk management tools utilized (cash, shorts, puts) and losses from resource sector positions.

At less than 70 cents-on-the-dollar versus our FMV estimates, our Global Insight holdings appear to be the cheapest, in aggregate, since we began the large cap only model over 3 years ago.

ProShares Short S&P 500, given our negative near-term outlook, is about a 10% weighting in most 100% Global Insight accounts. This is a long position in an ETF which mirrors the inverse performance of the S&P 500 on a daily basis. Therefore, it's a simple way of hedging against declines in the U.S. market, for reasons detailed above.

*SAP SE*, the world's largest provider of enterprise software and software-related services, reported strong FY '15 results. S/4HANA, SAP's next generation business suite, is seeing significant traction. Cloud revenue grew 30% year-over-year and is on pace to comprise 20% of '18 revenue vs. just 13% today. One of the key pillars to our original investment thesis was that SAP's cloud and SaaS vision are more focused than its competitors—this is clearly playing out. At 17x expected '16 eps, SAP is approaching our fair value estimate. We are likely to use SAP as a source of funds for more attractive opportunities that have arisen due to the recent market correction.

On February 4, government-owned China National Chemical Corporation, ChemChina, agreed to purchase *Syngenta* for $43 billion, or CHF465 per share. Syngenta's directors unanimously support the deal. Syngenta shares currently trade for around CHF400 per share, which infers a degree of skepticism about the deal by the market. Though a Swiss company, the biggest impediment to the deal comes from the Committee on Foreign Investment in the U.S., which could block the deal on the grounds that the acquisition represents a threat to national security. The acquisition comes just six months after Syngenta rejected a $47 billion offer from Monsanto, rumoured to come forward again with a new bid. With the political concerns surrounding the deal, we will likely redeploy funds into more attractive opportunities.

*Hershey,* the confectionary giant, recently reported a satisfactory quarter. Revenue continues to slow as volumes shrink, despite price increases. Operating margins were steady and the company beat estimates by about 3%. The company has struggled in China which had led to an overemphasis on this issue by the market, even though that region represents only 5% of overall sales. That said, the share price has acted well given the defensive nature of the business, allowing its share price to hold up relative to the market. We look for the share price to keep closing in on our FMV estimate of $105 per share where we expect to eliminate our position.

*Berkshire Hathaway* has detached too far from our estimate of its FMV—over $250,000 per Class A share, by our estimate, and rising—due primarily to concerns about softer insurance business and poor performance from its most visible long-term holdings like Amex, IBM, Wal-Mart and Coca Cola. In reality, the captive insurance businesses, rail and many other first-class assets now make up the majority of our valuation estimate. The company has a significant cash hoard which continues to build, has grown its book value per share about 11% per year in the last 4 years and a deep bench of executives to continue growing the company for years to come. Downside appears limited too, by the fact that, at 1.3x book value, the company is just above the level Buffett has insisted the company would buy back shares.

*Whole Foods Market,* the organic focused grocer, announced its latest sales and earnings that were ahead of expectations. Same store sales are still anticipated to be down slightly which remains the primary overhang. Though, square footage growth is expected to be robust for many years. We continue to believe the company's initiatives should turn into positive free-cash-flow momentum in the coming quarters. Marketing spending has increased and new smaller store launches have accelerated. This, combined with cost cutting, should offset the competitive concerns. Our FMV estimate is $38.

*21st Century Fox* is a leading global media company with assets including Fox TV stations, cable programming (e.g., Fox Sports, Fox News, FX) and film production. The latest results were slightly below expectations and guidance was reduced, mainly from the film business and foreign exchange pressures. While cord cutting may be impacting the value of distribution, the value of content generation remains high, particularly real time content like sports and news. Our sum-of-the-parts valuation is $35.

Canadian financial institutions are facing challenges—prolonged low interest rates, volatile financial markets, a lacklustre domestic economy, plunging commodity prices and an overheated housing market. We are watching the credit environment for signs of accelerating deterioration. In the case of *Bank of Montreal*, loan loss provisions were up 12% year-over-year; however, overall loan-loss ratios remained unchanged from a year ago at 21 basis points. We don't see signs of ballooning loan loss provisions in the near future. The challenges facing the sector are likely baked into current share prices. BMO's shares now trade at less than 11x '16 estimated earnings. More tantalizing is its 1.2x price-to-book ratio, a level not seen since the end of the financial crisis in '09.

In fact, a case could be made—for the first time in a long time—that the big five banks as a whole are attractive. To see material downside from here would require a North American recession or a prolonged period of sub-$30 oil, neither of which we foresee. FMV is about $85.

Shares of biotechnology giant *Biogen* continue to trade at a substantial discount to our fair value estimate of $380. Despite a decent 5-year expected eps growth rate of 8%, Biogen trades at 14x '16 estimated eps, a lower multiple than the S&P 500's P/E of 16x. Recent results came in ahead of expectations due to higher margins and a lower tax rate. The company also announced a meaningful reduction in its workforce in an effort to focus on fewer but more profitable projects. Biogen's $6.2 billion war chest enables it to make acquisitions which should fill the gap between the expected sales decline of Tecfidera (used to treat people with relapsing forms of multiple sclerosis) and its next generation of products.

*Xerox,* after coming under pressure from activist investors, is planning to add to its cost cutting program and split itself into 2 separate companies—a business process business and a documents technology business—by the end of the year. This should allow each management team to be more focused and provide a better fit for shareholders who tend to prefer a pure-play. The services business is also seeing an improved outlook which could, in the meantime, help move the price up toward our $12 estimated FMV.

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

In the last few months we added only three new positions, *NetApp, Pulte Homes* and *21st Century Fox* (noted above). We sold Jacobs Engineering Group, Prudential Financial, Eastman Chemical, Softbank, Goldman Sachs, Bed Bath & Beyond, Ford, CST Brands, Liberty Media, IBM and American Express as all triggered sell signals falling below their respective floors or inflecting down from ceilings. In the period, new additions—all at TRAC™ floors and at least 20% below our FMV estimates—include the companies detailed below.

*NetApp* is a storage solutions provider. Concerns about revenue growth, near-term dilution of its acquisition of SolidFire, and an increasingly competitive storage environment led to a steep decline in its share price over the last year. Our scenario analysis leads us to conclude that these issues are priced into the stock. Even if we were to assume a perpetual 5% decline in earnings growth, we arrive at a discounted cash flow valuation of $22, close to the current share price. We do not expect such a scenario. Cost cutting programs should stabilize margins. The SolidFire acquisition should be accretive within a couple of years. Meanwhile, NetApp is a potential target for activist investors or financially savvy acquirers. Net cash accounts for half of the company's $7 billion market cap.

Coupled with its annual free cash flow generation of close to $1 billion, an acquisition of the company would see a payback of less than 4 years. Our valuation estimate is $32.

Homebuilder *PulteGroup* reported solid '15 figures that saw recurring earnings rise 11%. Closing average sales prices in Q4 increased by 6% with gross margin rising 40 basis points to 23.5%. Over the last few years, Pulte's management has prioritized generating high returns on invested capital and shoring up the company's financial position. Return on invested capital closed the year at 7.3%, the highest since '06. Pulte's long-term debt/total capital stands at 30%, down considerably from the 50-60% range between '09 and '12. A strong balance sheet and management team focused on prudent capital allocation positions Pulte to capitalize on the continued U.S. housing market recovery. Our fair value estimate is $24.

**Income Holdings**

The 10-year U.S. government bond yield is 1.7%. Rates remain low, held back by the slow growth environment, high U.S. dollar and disinflation. We still believe higher rates are likely soon though. High-yield corporate bond yields have now risen to 9.4%. And, high-yield bonds remain in a bear market—TRIM™, our indicator of momentum, gave a sell signal in December of '14. Because of the spectre of rising rates, particularly in high-yield securities, and a dearth of attractive opportunities, we have essentially been inactive, purchasing just one position in the last 6 months and nothing in the last 3 months. Now that rates have risen substantially though, in this end of the market, we are more actively seeking opportunities, both via screening and our network of contacts, for risk/reward parameters that are attractive. We remain mindful that when high-yield rates rise to 8% above 10-year treasuries—which occurred in January—they typically underperform for several months. One year out though, is normally a sweet-spot for buying as the high-yield market then begins to seriously outperform.

We continue to hold a number of undervalued income positions and collect outsized interest income on these positions due to the depressed prices. Our income holdings have an average current annual yield (income we receive as a percent of current market value of income securities held) of about 9%.

Of note, regarding our top holdings in our income accounts: *Specialty Foods,* now an equity holding of a private company, held only in our taxable income accounts, is planning to return capital to us (see the reference under All Cap holdings above); *Sun Product* bonds (a private company held only in our taxable accounts) has solid earnings from its consumer staple business; *JAKKS Pacific's* convertible bonds may benefit from the possibility of a buyout; *Advantex Marketing* debentures remain secured by the company's asset base; *Ruby Tuesday's* bonds are well covered by underlying real estate; *Telecom Systems* has increased in value as the company is exploring strategic alternatives for enhancing value; *IBI Group* has benefited from the recent equity issue solidifying the bonds; *Brookfield Real Estate Services* continues to earn from the steady royalties based on the increasing number of real estate agents in its network; *Enerdynamic Hybrid Technologies* (see the reference under All Cap holdings above) should have a material earnings lift from new contracts; *Northwest International Healthcare Properties REIT* bonds are underpinned by a stable income stream.

**Value Will Out**

Value stocks, which almost always outperform over 10-year periods or more, have underperformed significantly since '07. Our peers, who also practice value investing, have grossly underperformed in the last year or so—as have the pure "quants" (those selecting stocks solely based on their underlying statistics)—illustrating the preference for growth at any price during this period. These neglected companies should again begin to outperform soon as their relative cheapness has stretched too far. Stay tuned.

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