April 2014

***"Deciding what not to do is as important as deciding what to do."***
-Steve Jobs

## Stay the Course

For the past five years, we have focused our research efforts on searching for value in equity and fixed income markets, while never losing sight of our primary mandate: preservation of capital.

The table below offers some perspective.

| 15-year annualized total returns (in CAD$) | | 15-year annualized Canadian inflation* |
|---|---|---|
| MSCI World | 2.0% | 2.0% |
| S&P500 | 2.3% | |
| TSX | 7.8% | |

*S&P Capital IQ

Over the past fifteen years, investors have not experienced much in the way of returns. The dotcom mania and the financial crisis shared little in common, except for one thing: valuations for certain asset classes became priced for perfection. The risks far outweighed the potential rewards. Yet before both bubbles had burst, investors were loath to hold cash, lest they miss out on potential riches.

**A diversified portfolio, but some common themes...**

Each investment that we make has to meet strict criteria, both financial and qualitative. To minimize risk, we have always maintained a well-diversified portfolio and our value discipline has kept us out of some of the troubled areas of the market (such as gold and other precious metals). That being said, by doing so we will undoubtedly continue to miss out on the occasional high flyer, such as Facebook and Twitter – both of which may be excellent, well-run businesses, but neither of which offers very much protection on the downside if expectations fall short. This is why we prefer to make investments in companies with successful operating histories whose shares have been punished for reasons we judge to be temporary. Think of companies like Alcoa, Allstate, Hewlett Packard, ING and Yamaha. Each of these companies has been around for a very long time. Each has built successful franchises. Yet each has also suffered, at a moment in time, from either difficult industry conditions (Alcoa) or management mistakes (Hewlett Packard).

Many companies meet our criteria for financial strength and quality. However, a great company is only a great investment when its share price is cheap. If we cannot find enough compelling investment opportunities, then we will hold cash and wait. The only way to deliver attractive returns over the long-term, while preserving capital, is to patiently wait for situations where the risk/reward ratio is stacked in our favour.

**Current market conditions and the temptation to stray…**

After a period of strong investment returns, valuations for most asset classes are rather full. Our investment committee meets regularly to discuss existing investments, review the macro environment and present potential new investments. As market valuations have increased, it has become harder to find interesting opportunities.

Markets in the developed world have had a great run, while emerging markets (most notably Russia and China) have lagged. The recent incursion into the Ukraine has resulted in many Russian equities falling to what appear to be distressed levels. The oil and gas sector in particular is trading at a fraction of oil and gas shares elsewhere.

With such a divergence of valuation, combined with the difficulty of finding value in the developed world, it can be tempting to step out along the risk curve and invest in these markets. However, adhering to a strong set of principles ensures that we avoid the temptation to stray into areas that are simply too risky. One of our principles is that we only invest in markets governed by the rule of law. While Russian shares certainly look cheap on the surface, the severe lack of appropriate corporate governance and level of corruption simply pose too much risk. BP found this out several years ago, when government pressure caused their venture with TNK to be "renegotiated" on unfavorable terms and without their approval. However, BP had no choice but to accept it.

China is a very different situation.

**China at a glance**

Given that China has recently become the world's second largest economy, investors have started paying closer attention to the economic data coming out of that country. Indeed, China has been one of the major drivers of global economic growth over the last 15 - 20 years. The country's growth rate is still expected to exceed that of developed markets in 2014, with policy makers expecting GDP growth of 7.5%. However, what concerns investors is that the pace of this growth has been gradually decreasing. To prop up economic activity, the Chinese government has recently announced a stimulus package that consists of increased spending on affordable housing, railway construction, water conservation projects and energy savings. Aside from these fiscal measures, changes in monetary policy are also anticipated. The most likely of these would be a decrease in the reserve requirements of Chinese banks. This would allow the banks to lend out more of their capital, rather than keep it tied up with the central bank.

Nevertheless, there are a number of risks to the Chinese growth story. One risk is the sustainability of the real estate market. While housing prices in larger Chinese cities have been rising for quite some time, analysts have long highlighted the risk of a drop in property values. The fear is that this could lead to liquidity issues for some of China's larger property developers. Related to this issue are the risks inherent in the Chinese banking sector. The Chinese banks have been lenders to property developers and other industries that are dependent on the sustainability of the construction sector. According to the China Banking Regulatory Commission (CBRC), Chinese banks' non-performing loans ratio rose to its highest level in two years in the last quarter of 2013. The CBRC has urged banks to slow down lending to local government financial vehicles (LGFVs) and industries facing overcapacity, including real estate and steel-trading firms. Finally, there are also concerns regarding the debt levels of China's local governments, which includes provinces and the larger cities. At the end of 2013 China's national auditor revealed that the liabilities of local governments had grown to Yuan 10.9 trillion ($1.8 trillion) by the middle of last year (The Economist). While the debt levels vary from province to province, the risk is that at some point, China's central government will have to step in to provide support in order to prevent a crisis.

As with many emerging markets, there is also a lack of transparency regarding accounting standards and shareholder rights.

While there is little doubt that China will remain a growth story for a long time to come, the many risks outlined above leave us uncomfortable owning Chinese shares. We prefer to participate in China's growth by investing in global businesses (notably in Japan) that derive a substantial portion of their revenue from exports or through foreign subsidiaries.

**High Yield Bonds**

A review of the high yield bond market and our high yield fund is available here: High Yield Quarterly

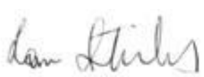
**Final thoughts**

Our investment discipline is designed to deliver reasonable returns over time, while minimizing risk and preserving investor capital during difficult markets. If investors can avoid disaster years (2000-2001, 2008-2009) long-term returns should be more than adequate.

With valuations at current levels, we are more than comfortable with our cash position. Our returns will come from buying strong companies that were are out of favour. We will not stray from this conservative approach.

As always, we welcome the opportunity to discuss our outlook and investments with you.

Sincerely yours,



Lorne Steinberg
President

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