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"Money for nothing"

There was no shortage of bad news this quarter: Japan's earthquake and nuclear disaster, the spike in oil prices caused by Middle East turmoil, further credit rating downgrades for Greece, Portugal and Spain, the double dip of U.S. housing prices, and rising inflation prompting the European Central Bank to raise its benchmark interest rate. Despite all of this, cheap money drove equity markets higher.

Crisis in Japan - "This too shall pass"

The earthquake and tsunami that hit Japan is a horrible human tragedy which has claimed countless lives. It will take years and significant capital for the affected areas to recover from the devastation, and the ultimate impact of the nuclear meltdown remains unknown.

As with almost any major disaster, talk of the worst case scenario quickly monopolizes the airwaves as we are flooded with horrific images by the media. Fear and uncertainty cause investors to panic and many head for the nearest exit. However, markets generally tend to overreact to disaster headlines, causing the pendulum to swing too far. When the headlines subside, there comes the realization that "this too shall pass." These events (the BP oil spill, 9/11, the Cuban Missile Crisis, etc), in retrospect, invariably turn out to be great investment opportunities. There will undoubtedly be short-term economic fallout in Japan, but like the Kobe earthquake in 1995, we expect activity to recover as rebuilding takes hold.

As global value investors, we are unconstrained by geographical limitations in our search for opportunities. Japan remains one of the best hunting grounds for value and the post-earthquake fears make this market even more compelling. That being said, the Nikkei index was already at such a low level beforehand that the crisis has not caused a significant drop in the market (presently down approximately 7% from pre-earthquake levels).

Our investments in Japan are heavily protected on the downside, as many of the companies have no debt and trade for less than the cash they have in the bank. Despite the recent turmoil, virtually all of our investments are still trading above their respective cost prices. Since we had already been studying this market for quite some time, as soon as the market fell we were able to capitalize and invest in several other great companies that we had been following. It appears we were not alone. Following an endorsement by Warren Buffett that the earthquake provided a "buying opportunity," foreign investors bought a record $11 billion of Japanese stocks.

Throughout the crisis, what has especially stood out is the remarkable conduct and resolve of the Japanese people. These are the type of qualities we find embedded in both Japanese culture and, by extension, the companies in which we invest.

Recent purchases

As we mentioned, following the earthquake we made several Japanese investments: Yamaha (musical instruments/electronic devices), Kawasumi Laboratories (medical devices) and Yodogawa Steel Works (steel). All are large exporters, have virtually no debt and trade at compellingly cheap prices.

The market jitters in March afforded us the opportunity to make several other purchases during the quarter as well:

<u>Novartis</u>
Novartis AG, based in Switzerland, was founded in 1895 and is one of the largest pharmaceutical companies in the world.

Many pharmaceutical companies have come under pressure, challenged by tougher regulatory oversight, price cuts, costlier lead times and health care reforms. Perhaps most important, however, is the effect generic competition will have as patents expire on key drugs. Novartis, while not immune, is less exposed to these issues, as it is comprised of three distinct business units: pharmaceuticals, generics (Sandoz) and eye care (Alcon). As many blockbuster drugs will soon come off patent, generic manufacturers like Sandoz are well positioned to gain market share. Alcon is also poised for healthy growth, with eye care being one of the fastest developing segments in the healthcare space. Novartis has an excellent track record and has raised its dividend for fourteen consecutive years. At the price we paid, the dividend yields 4.4%.

<u>Cisco Systems, Inc.</u>
Cisco Systems, Inc. designs, manufactures and sells networking and other products related to the communications and information technology industry worldwide. Since its 2007 highs, Cisco's share price has fallen nearly in half. Shortly after we invested in the company, the Board of Directors approved its first ever quarterly cash dividend. Cisco's cash stockpile is nearly 25 billion dollars, affording the company enormous financial flexibility. With short-term product transitions and hiccups in IT spending (most notably in the public sector), the company has disappointed investors in the last few quarters, which has put pressure on the stock. However, we do not consider these to be secular issues and long-term we believe they have good prospects in data center switching, routing and optical networking products.

<u>Xerox Corporation</u>
Founded in 1906, Xerox Corporation provides document equipment, software, solutions, and services worldwide. Having recently acquired data powerhouse Affiliated Computer Services (ACS), the copy-machine icon has begun transitioning into other areas, most notably data services. Xerox has a strong track record of cost discipline. We believe they will hold or take market share in the production and office segments and that, long-term, the cross-selling opportunities from ACS and their services business will support a healthy growth profile. At the

price we paid, their shares are trading at roughly half their pre-recession level and their dividend yields approximately 1.6%.

The end of cheap money?

Money has rarely been this cheap. Short-term interest rates throughout most of the world are currently lower than the rate of inflation – an unsustainable situation. In the U.S., the Fed has propped up the bond market by printing money (quantitative easing), but the $600 billion liquidity tap will be turned off in a few months. It is no wonder that Bill Gross of Pimco (the world's largest bond fund) recently sold his entire position in U.S. government-related debt. When the Fed stops buying U.S. debt, the void will need to be filled and we expect interest rates to rise. Higher interest rates are negative for just about every asset class, **except for cash**.

When valuations are extreme, so are the reversals.

As we have said many times, the only way to preserve capital is to hold cash when the risk-to-reward ratio is unfavourable. At present, we believe this ratio makes it prudent to hold a significant cash position.

Investor sentiment can change course quickly. When it does, one is either early or late. **We have chosen to be early.**

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

Sincerely yours,

Lorne Steinberg