April 2012

No Shortage of Black Swans

Dear Client,

The first quarter provided investors with a ray of sunshine after what was, for many, a bleak 2011. Despite the welcomed sight of bluer skies, the strength in the markets has been driven more by central bank policies than by economic fundamentals. Recent comments by Fed Chairman Ben Bernanke on the state of the economy implied: *don't trade your umbrella for a beach chair... just yet*. With the Fed indicating that they are unlikely to embark on further quantitative easing in the near term, markets weakened – **a reminder that investors should focus on value, rather than relying on monetary stimulus.**

The Canadian market has lagged behind most international markets, as slowing growth in emerging markets weighed on the energy and materials sectors. Japan, on the other hand, was among the best performing markets, boosted by yen depreciation, positive comments from their central bank and an improved economic outlook.

In general, the world remains in a state of confusion, with the global economy sputtering and policy makers unable to get it moving under their own steam. The market theme remains one of ongoing volatility.

The economy

The laundry list of global risks has not shortened appreciably.

In Europe, the soap opera continues and is now into its third season. Greece has an election on May 6 and opposition politicians are threatening to derail the recent debt restructuring. Spain, the lead character this year, risks losing the confidence of the bond market as its recession deepens and it tries to manage 24% unemployment.

The eurozone is being affected by an austerity-debt spiral, whereby austerity programs result in deeper recessions, forcing yet further austerity. This is a departure from standard Keynesian economic policies of the post-war world. In recessions, governments generally increase spending during a downturn in order to stimulate the economy. However, in the present environment, the most affected eurozone countries do not have the financial flexibility to do so. This fragile situation is being further exacerbated by eurozone banks, who in the wake of facing potential credit rating downgrades are holding onto cash instead of lending it out. Suffice to say, the eurozone problems are far from over.

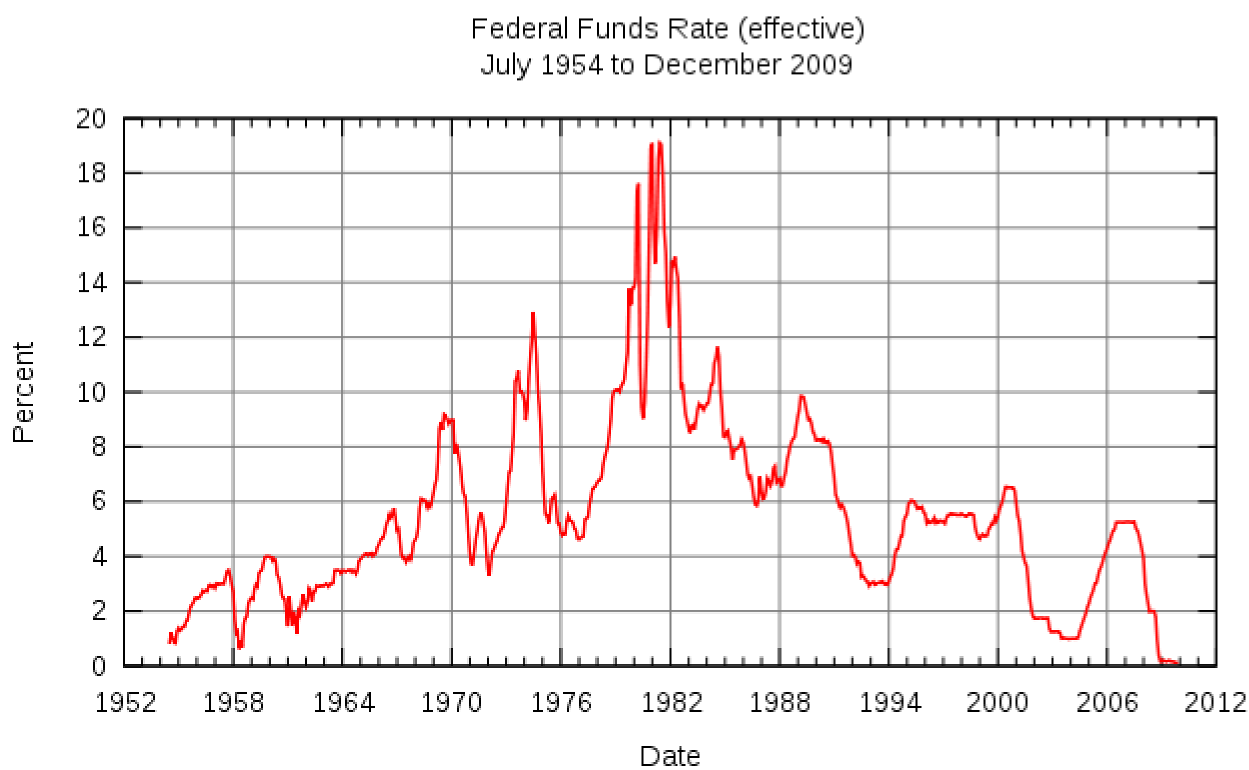
Though Europe has been taking center stage, issues have also been surfacing in the global growth engines of the BRIC countries. China, for instance, recently announced that GDP growth slowed in the first quarter to its lowest level in almost three years. India and Brazil are having the same experience.

Closer to home, the U.S. continues to improve, but at a sluggish pace. The long-term fiscal imbalances remain unresolved. After the election in November, the deficit will be addressed with cost-cutting and higher taxes, which will negatively impact growth. In Canada, the government has embarked on a plan to strengthen the country's finances through spending cuts and reforms to programs for the aged.

Christine Lagarde, Managing Director of the IMF (International Monetary Fund) perhaps best describes the current environment in her recent statement that **"We have seen some improvement in the economic climate. But let me also underline this point: the risks remain high; the situation fragile".**

The deleveraging hangover

In the early 80s, short-term interest rates in the U.S. peaked at 20%. In Canada, the prime interest rate reached as high as 23.75%.

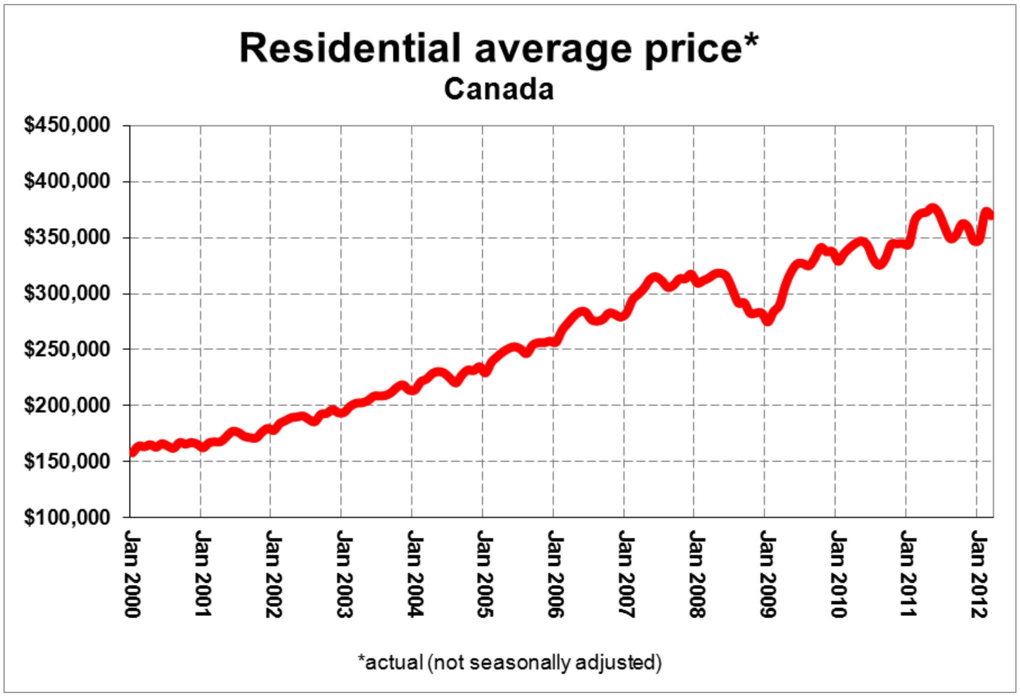


Over the past three decades, interest rates have been on a fairly steady downward march, encouraging excessive borrowing and over consumption by both individuals and countries. With rates taking the longest pause since the 1950s, we may have reached the inflection point. Inflation continues to remain above the level where central banks are comfortable and interest rates are poised to rise.

The massive bursts of liquidity provided by central banks are just about finished. This was echoed in the most recent Monetary Policy Report that signaled that **"some modest withdrawal of the present considerable monetary policy stimulus may become appropriate."** We are in the early stages of a global deleveraging cycle.

In Canada, where the economy has held up far better than most, the central bank has been growing increasingly worried over the level of consumer debt and housing prices. This is understandable, given that the country's household debt-to-personal disposable income ratio has climbed to a record high of over 150%, which is not far from the level reached in the U.S. before the housing market collapsed.

The Canadian Real Estate Association recently pegged the average price for Canadian homes sold in March at $369,377. Housing prices have risen by over 7% annually for the past fifteen years, while inflation has been averaging about 2% and wage growth about the same[1]. This is not a sustainable trend. As mortgage rates start to rise, housing prices will most certainly decline, putting an end to the construction boom.



CREA -- April 16, 2012 -- http://creastats.crea.ca/natl/

Unbiasing the bias

Almost everything that we are writing about can be found on the front pages of daily newspapers. However, investors are choosing to ignore all of these potential "black swans". Behavioural finance teaches that investors are prone to a "recency bias" -- that is, a bias that stems from being predisposed to believe that trends of the recent past will continue. Thus, when markets are rising, people want to "buy", believing that markets will continue to go up, regardless of value. Just think of the U.S. housing market. However, history has shown that every time the concept of value is ignored, investors end up getting hurt. Large corrections can happen before one has time to blink (as the saying goes, markets often take the stairs up but the elevator down). Unless investors prepare for these moments, they are simply left wondering how they missed all the signs.

[1] http://www.statcan.gc.ca/tables-tableaux/sum-som/l01/cst01/govt19a-eng.htm

Japan - signs of change

The recency bias applies to investment attitude towards Japan. The stock market of the world's third largest economy has been in decline for so long that reality is being ignored. The value in Japan is, to some degree, the inverse of the dot-com bubble. In the late 1990s, internet share prices defied gravity, but investors ignored the numbers and believed a new era had dawned. Today, investors are also ignoring the numbers. The value in Japan is being ignored simply because it is easier to believe that trends will continue -- precisely the reason it is so cheap! But nothing stays cheap forever.

Recent Investments

<u>C. Uyemura</u>

C. Uyemura (founded in 1848) is a Japan-based chemical company that produces surface finishing materials and machinery. It is a global business, with over half of the revenue coming from outside of Japan. It has a leading market share in metal finishing in the electronics industry and is a market leader in plating in other industries, such as automotive and decorative finishing. Their plating chemicals are also used in the manufacture of smartphones (such as the iPhone), which has been experiencing solid demand and should continue to grow. The company carries virtually no debt and has a long history of growth in their niche market. With over half of their stock price being cash, it is trading under 10x earnings and pays a dividend of approximately 1.8% - compelling value and exceptional quality.

<u>Yushiro Chemical Industry Co. Ltd</u>

Yushiro Chemical, another Japanese-based company that we invested in recently, manufactures and sells metalworking oils and fluids and building maintenance chemicals. It is a global business with subsidiaries in other parts of Asia, Europe, North America and South America. Its products are used in automobile manufacturing, steel production, building maintenance, as well as in various other areas of manufacturing. The advantages the company enjoys over its peers in the field of cutting and grinding oils and fluids have allowed it to capture an overwhelming 60% market share in the automobile industry. The company was founded in 1944, has very little debt and a long history of generating profit and free cash flow. The shares trade at a significant discount to book value and pay a 3% dividend.

Final Thoughts

Markets are likely to remain volatile. We are armed with a large cash position and remain patient, but ready to act as opportunities present themselves. Capital preservation is of paramount concern. In the words of Aristotle, ***"The aim of the wise is not to secure pleasure, but to avoid pain"***.

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

Sincerely yours,

Lorne Steinberg