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"…the less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs." – Warren Buffett

Prudence

Dear Client,

Equity markets declined during the second quarter as investor optimism fell back to earth.

The policy decisions taken during the financial meltdown succeeded in avoiding a full-blown economic crisis, but the structural problems were never addressed. The developed world continues to suffer from excessive debt (both government and consumer), high unemployment and an oversupply of housing. There is no magic solution. Governments are dealing with these issues by implementing often severe austerity programs. The U.S. is running out of ways to delay that which is inevitable – higher taxes and lower spending. This will invariably cause growth to slow and it will take several years for the imbalances to correct themselves.

In the U.S., "QE2" (the second round of quantitative easing) has come to an end and Ben Bernanke has indicated that there will be no new monetary stimulus in the near future. The spotlight has shifted to the U.S. debt ceiling, where the lack of political progress has caused the major rating agencies to place the U.S on a "negative watch." We have no doubt that the debt ceiling will be raised for what will be the 75th time since 1962. The bigger issue is the impact that spending cuts will have on the U.S. economy.

Markets are often myopic and driven by short-term news. The vote in Greece to adopt harsh austerity measures has given markets short term relief, but only delays what has become a near certainty: Greece will eventually default on its obligations – the first developed country to default since the Second World War. With Portugal and Ireland also downgraded to "junk" status, the recent volatility in the market is warranted, as issues surrounding eurozone contagion and its potential consequences remain unresolved.

It is hardly surprising that markets have been weak, given stubbornly high inflation and the recent downgrade of the IMF's global economic outlook. At this time, we maintain our view that defense is the best offense – the risk-to-reward ratio is still not favorable and we are holding a large cash position. That said, market turbulence creates opportunity and we continue to find great value in select companies.

Recent Investment: Overseas Shipholding Group

Founded in 1948, Overseas Shipholding Group (OSG) is a major shipper of crude oil. They operate in a deeply cyclical industry and a downturn in day rates (the rental price of its ships) has caused the share price to drop from $77 in 2007 to about $27. Contrary to what one might expect, high oil prices are actually negative for OSG, as fuel is the largest cost component of transporting crude oil. Middle East turmoil has resulted in some dislocation in the shipment of crude, but management has reduced costs in the interim until industry conditions improve. OSG is an industry leader and has recently taken delivery of several new ships considered to be best-in-class. This leaves them in great shape when the cycle turns. There has recently been significant insider buying of the shares and the dividend yield is approximately 6.5%.

Chinese equities – Buyer Beware

We have been asked many times why, given China's attractive growth prospects, we do not invest in Chinese companies. Our answer has always been that we do not feel it prudent to invest in countries where the "rule of law" is not enforced.

While China's growth profile is an obvious attraction (according to the CFA Institute, China is projected to be the largest economy by 2050, surpassing even that of the U.S.), many public companies appear to be run for the benefit of insiders. The lack of transparency makes performing appropriate due diligence nearly impossible and the oversight from outside auditors is suspect. Proper regulatory controls are lacking and accounting standards for public issuers do not meet accepted norms.

The financial statements of many Chinese companies appear so attractive that it is hard to resist the temptation to invest in them. We recently analyzed several such companies that, on paper, looked **too good to be true** – several months later, it appears this was in fact the case. Sino-Forest is but one of several examples that are now coming to light, where years of financial statements may have been overstated.

In order to gain exposure to rapidly developing markets that lack appropriate governance, we believe that it is best to limit investments to companies in developed markets that export to such geographies, which is one of the reasons why we have invested in several Japanese exporters.

Japan

It has been four months since the tsunami and nuclear accident hit Japan. In that brief period of time, it is remarkable how quickly the companies impacted by the disaster were able to resume operations. The supply chain issues affecting the auto industry, for example, have been much less severe than predicted, and will be mostly resolved by the end of the summer. Compared with most of the world, where we believe economic activity will remain subdued, Japan will actually receive a GDP boost from its efforts to rebuild the affected areas.

The Nikkei index has rebounded and is currently trading at nearly the same level as before the disaster, while the value we are finding in Japan remains second to none. Many of the companies we own are performing very well, yet all remain extraordinarily cheap. Topre, a parts manufacturer specializing in plastic forming and press technologies, is one such company that we invested in only a few months ago. Despite a 40% increase in its share price during the second quarter, there is still plenty of upside. Japan is simply off the radar for most investors. If these companies were listed on the New York Stock Exchange, they would be trading at significantly higher prices. While one never knows precisely when value will surface, the dividend yields we are receiving are in excess of the yield on ten-year government bonds.

Final Thoughts

Patience is indeed a virtue when it comes to investing. The concept of "buy low and sell high" is easy to grasp, yet it is rarely followed. In order to "buy low", one must have the patience to wait for share prices to fall. This means holding cash, even in a low interest rate environment – an uncomfortable position for most investors.

We have been diligently building a portfolio of high quality companies that we invested in at excellent prices. Should market volatility continue, as we anticipate, we will have ample opportunity to invest our cash at prices that allow for substantial upside.

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

Sincerely yours,

Lorne Steinberg