July 2012

One Step Forward, Two Steps Back

Dear Client,

Equity markets declined over the past three months, as first quarter optimism quickly faded. With a sharp drop in commodity prices, Canada was among the weakest performers. Good news was hard to come by. U.S. growth has slowed while Europe stumbles from one crisis to the next. Even emerging markets are suffering from the global malaise. It is hardly surprising that the International Monetary Fund reduced its economic outlook for 2013.

In Europe, leaders are trying to keep the union together despite ongoing setbacks. Greece's new government is already backtracking on guarantees made just a few months ago and the recent bank bailout in Spain has failed to curtail its unsustainable borrowing costs.

It is hard to envision any quick resolution to the Euro crisis without Germany agreeing to provide financial guarantees to the affected countries. In return, those members would need to surrender sovereignty over their budgets and banks - a remote possibility at present.

In the U.S., the most recent Federal Reserve Board statement says it all: *"Most participants saw the incoming information as indicating somewhat slower growth in total demand, output, and employment over coming quarters than they had projected in April, and most carried forward some of that downward revision to their projections of medium-term growth."*

With governments implementing austerity programs and central bankers out of ammunition, it is hard to see growth returning to pre-recession levels any time soon.

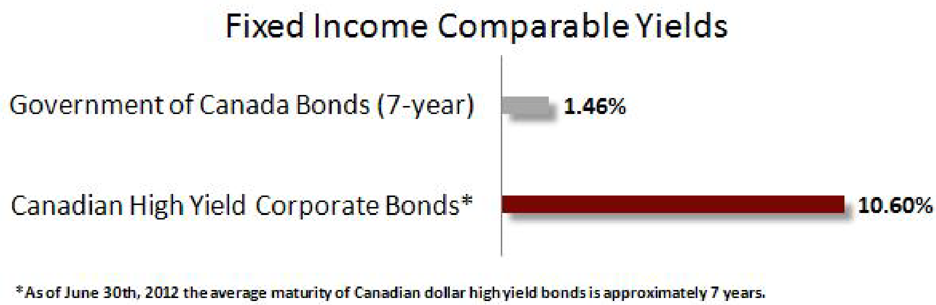
All of this suggests that interest rates will remain at current levels well into next year.

Shrinking yields - buyer beware!

For many years, conservative investors could put a portion of their investments in government bonds and GICs and earn a comfortable mid-single digit return, which exceeded inflation by a considerable margin. Today, 7-year Government of Canada bonds yield a paltry 1.5%, which is less than inflation. Shorter-term bonds yield even less.

There is no value left in high quality fixed income and buyers of long-term bonds and GICs will be hurt when interest rates start to rise. The old adage attributed to the late Shelby Collum Davis rings true: **"Bonds promoted as offering risk-free returns are now priced to deliver return-free risk."**

The only real value in fixed income is found in the high yield bond market, where yields are attractive and credit spreads remain elevated.



Japan

Though Japan has been mired in a long period of high fiscal deficits and anemic growth, its economy is actually expected to grow faster than most of its G8 peers this year. The government has also been making strides to more forcibly tackle the deficit by doubling the consumption tax over the next few years.

The Yen has been one of the strongest currencies over the past five years (appreciating over 30% versus the U.S. dollar). While this hurts exports in the short-term, over time it should result in improved productivity and opportunities for Japanese companies to expand their global footprint. Masaaki Shirakawa, Governor of the Bank of Japan, recently put things in perspective: Japan's economy has actually grown as fast, if not faster, than most developed nations over the past decade on a per capita basis. It is also worth noting that the unemployment rate in Japan is only 4.4%, far lower than most of the developed world.

All considered, in a world fraught with uncertainty, Japan is much better positioned than most seem to think. We continue to find unique opportunities in Japan and believe it remains one of the most undervalued markets in the world, with global companies trading at a fraction of what they would command elsewhere.

Despite weak equity markets, our Japanese shares are paying excellent dividends and performing well.

Recent investments

For those with cash to spend, uncertain times like these tend to offer the greatest buying opportunities. We made several compelling investments this quarter and continue to maintain a healthy liquidity position.

<u>Riken Keiki (TSE:7734)</u>

For over 70 years, Riken Keiki has been manufacturing detection and environmental measurement equipment. Their products, which are sold in Japan and internationally, are used to monitor toxic gas leakages and prevent industrial disasters. The recent catastrophe in Japan has caused a renewed focus on improving workplace safety and an increase in demand for prevention and early warning systems. Riken Keiki is in a great position to benefit. Their sales have been steadily increasing and their specialized technology allows them to command high margins. They carry little debt and their business generates ample free cash flow. The shares have been knocked down substantially and now trade for 7x earnings, 0.5x tangible book value and less than the company's net-working-capital. They are flush with cash and pay a well supported 3.3% dividend yield.

Total S.A (ENXTPA:FP)

France-based Total S.A is one of the largest international oil and gas companies in the world. Its shares have recently come under pressure due to an offshore accident. As value investors, we are always on the lookout for great companies whose shares have fallen out of favour because of temporary factors. In this case, the fears associated with the recent BP incident caused investors to panic. However, these concerns were vastly overdone – this was nothing at all like the BP situation and investors had simply overreacted. At this point the leak has been plugged and they are working on restarting production. Estimated damages are nowhere near the loss in value the company's shares experienced. At the price we paid, our dividend yield is over 6%.

Hirano Tecseed (OSE:6245)

Hirano Tecseed manufactures coating and laminating equipment based on specialized heat and air technologies. Founded in 1935, the company has become a leading manufacturer of lithium ion battery electrode coating systems, an area likely to see growing demand as electric vehicles become more popular. They also manufacture touch panels in smartphones, a fast growing industry. This is a global business (45% of revenues are foreign) with a strong reputation for reliability and performance (they offer the fastest coating speeds in the world). Hirano Tecseed also operates Technicum, one of the world's largest testing facilities and an area that has been experiencing increasing demand.

The technology barriers to entry are high and there are few competitors in their field. The company has a strong financial track record, carries virtually no debt, generates healthy levels of free cash flow and pays a 2.7% dividend. Its share price has dropped dramatically in the last few years and is now trading at attractive multiples – roughly 7.5x earnings and under 0.4x tangible book value. If that is not compelling enough, the company also has about $120m in net-cash, yet is only valued in the market at $80m.

Final thoughts

We are living in a time of heightened uncertainty and our focus on preserving capital has been serving us well. The fallout from the financial crisis will be with us for some time, resulting in global deleveraging, weak economic output, volatile markets and investor pessimism – the ideal environment for value investors such as ourselves.

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

Sincerely yours,

Lorne Steinberg
President