

"Most people get interested in stocks when everyone else is. The time to get interested is when no one else is. You can't buy what is popular and do well."

– Warren Buffett

October 2011

Finding Opportunity in Volatility

Dear Client,

There is an old saying on Wall Street that *stocks take the stairs up and the elevator down*. Investor confidence certainly changed quickly this quarter and a stock market which seemed to be ignoring all the risks suddenly tumbled. Most global equity markets fell by over 10%. Some equity markets, such as Germany and France, fell by as much as 25%.

There were few new developments during the quarter, simply continuations of the same themes that have been front and center for over a year – high sovereign debt levels (most notably in Europe), sluggish economic growth in the developed world, persistent unemployment and rising inflation. Of these, Europe is undoubtedly the most worrisome. Italy and Spain had their credit ratings cut further, as did several French banks. With France and Germany unable to agree to a solution, there are few signs that a "quick fix" will be implemented any time soon.

Euro contagion fears are impacting many of the region's banks and have recently claimed a new victim: Dexia, a large Belgian-French bank that required a bailout and which is slated to be dismantled. Large depositors, such as multinational corporations and money market funds, have been reducing their exposure by withdrawing funds from these financial institutions, exacerbating the problem. As a consequence, these financial institutions are forced to raise deposit rates (to attract depositors) and curb lending (to preserve capital). There is little doubt that any solution to stabilize the banking sector will require a significant capital injection, possibly in excess of one trillion Euros.

Both the International Monetary Fund and the Federal Reserve Board lowered their forecasts for global growth through 2012. Central bankers are pulling out all the stops in an attempt to stimulate demand and avoid a double dip recession. Ben Bernanke enacted "Operation Twist," an attempt to keep long-term interest rates at post-World War II lows. The Bank of England is following suit by increasing the size of its asset purchase program. The risk of these policies is that they cause inflation to rise, which would force central banks to raise rates and potentially choke off an already weak recovery.

Recent purchases

Over the past year, we have held to our thesis that equity markets were not reflecting the many risks that existed and that holding cash was the only prudent course of action. Our patience and large cash position has started to pay off. During the quarter we had the opportunity to invest in several new

companies: Allstate, Morgan Stanley, Koninklijke Philips Electronics, Corning and Teikoku Sen-I. The common theme among all of these companies is that they are financially sound, well positioned for growth and their share prices have fallen to compelling levels. *Great businesses are only great investments if they are purchased at cheap prices.*

Koninklijke Philips Electronics

Founded in 1891, Koninklijke Philips Electronics is a world-class company that is poised to benefit from a number of new products in the lighting and healthcare industries. It generates a healthy level of free cash flow every year from the diverse product offering that it sells worldwide. Its shares have fallen by approximately 40% this year and at the price we paid the dividend yield is nearly 5% – a level at which we do not need substantial price appreciation for it to deliver attractive returns.

Teikoku Sen-I

Headquartered in Tokyo, Japan, Teikoku Sen-I has been in business for over a century. As a business that primarily engages in disaster prevention, they offer solutions to firefighting, search and rescue, as well as to large-scale natural disasters, such as earthquakes, tsunamis, extreme weather, epidemics and terrorism. With Japan's recent natural disaster, they are in a great position to grow their niche business. They have no debt and their share price, which trades below book value, is over 60% net cash. They have also been steadily increasing their dividend, which currently yields 4%.

Corning

Corning is a global leader in specialty glass, a popular example of which is the protective "Gorilla Glass" used to build Apple's iPhone and other smartphones and tablets. The company transformed itself from the dotcom days when it was a leader in fiber optic cable (which it still produces), a testament to management's ability to adapt in a fast changing world. The company has over \$4 billion of net cash, ongoing free cash flow, and is well positioned for long-term growth.

Allstate and Morgan Stanley are two well-run financial companies whose shares have been battered despite strong fundamentals.

The answer to low interest rates

Bond yields have fallen to their lowest levels in sixty years, with the 30-year U.S. Treasury bond yielding only 3%. When yields are this low it is usually a precursor to a recession, but today it is more likely a reflection of investor fear. With inflation hovering around 3%, investment grade bonds no longer offer any upside. Government bonds and GICs are losing ground to inflation, leaving investors with erosion of their capital. While our [High Yield Fund](#) has not been immune to the market volatility, the fund is well diversified and we are taking advantage of our cash position to buy bonds with an average yield in excess of 9%.

Final thoughts

The major risks in the world have not changed and we believe markets will remain volatile. As we have mentioned many times, when risks are elevated, a prudent (and smart) investor holds cash in order to benefit from a change in investor sentiment.

Growth and capital preservation are not mutually exclusive. In order to grow capital, it must be

protected in down markets. Those who remain fully or nearly fully invested at all times simply ride the market roller coaster up and down.

We remain patient, but are ready to act as opportunities present themselves. As always, we welcome the opportunity to discuss our outlook and investments with you.

Sincerely yours,

A handwritten signature in dark ink, appearing to read "Lorne Steinberg".

Lorne Steinberg

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