January 2012

"Two roads diverged in a wood, and I—
I took the one less traveled by,
And that has made all the difference."
–Robert Frost

12 Months ending December 31, 2011	
TSX (price return / total return)	-11.1% / -8.7%
S&P 500 ($US / $Cad)	0.0% / 2.3%
MSCI World ($US / $Cad)	-7.6% / -5.3%

The Road Not Taken

Dear Client,

In our 2010 year-end letter, we wrote about the many risks that existed in financial markets. We suggested that prudent investors maintain a large cash position in order to protect themselves should some of those risks come to pass.

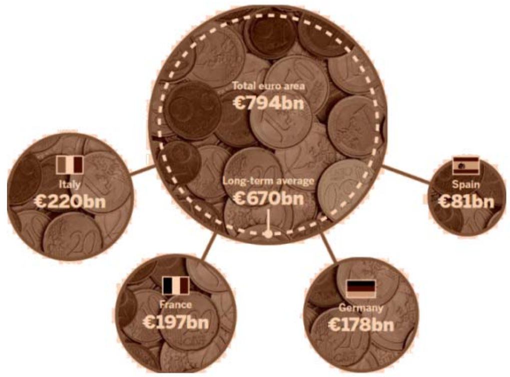
Cash was king in 2011, as eurozone turmoil, sovereign credit rating downgrades, slowing growth in developed and emerging markets, and ongoing weakness in the U.S. economy impacted investor confidence. We were very well positioned in 2011. Our large cash position served both to protect capital and allow us to take advantage of market weakness. Few cheer when markets fall, but those flush with cash are able to succeed in the first part of "value investing" – **"buy low."** As markets fell, we were able to invest in a number of great companies, many of which were trading near **multi-year lows,** with **high dividend yields** and plenty of **upside**.

Many of the risks that we talked about last year remain in place, with Europe still at the top of the list.

Europe - crisis or resolution?

After a number of fits and starts, European leaders seem determined to bring resolution to the crisis in 2012. It is too early to know what the ultimate solution will look like. At present, Germany is trying to minimize its financial commitment and install strict rules on fiscal miscreants, while Italy and others want greater guarantees from the stronger countries in order to lower their future interest costs. The constant is that negotiations are ongoing, and the leaders of the major players are all focused on resolving the problem.

Eurozone bonds needing to be issued in 2012



Source: Financial Times

The immediate challenge is that the eurozone needs to issue €800 billion of new bonds this year, a larger amount than usual. Investor confidence will be critical in keeping the interest rate at a manageable level. Standard and Poor's has recently highlighted these risks and cast their vote by downgrading the ratings of many European countries, including France, Italy, Austria and Spain. The European Central Bank has been providing liquidity, in the form of unlimited three-year loans to eurozone banks, which has restored some confidence in the bond market. The issue of Greece remains on the front burner -- whether there will be an "orderly" or "disorderly" default, whether bondholders will accept what now looks like a ⅔ "haircut" and whether the agreed upon austerity program will be implemented in time for the €14 billion needed in March. The possibility of Greece leaving the Euro remains, but before this would happen we expect the remaining members would take the necessary steps to minimize the contagion.

While the path forward in Europe will certainly be bumpy, a number of developments have been paving the way for a lasting monetary union. We have come to the conclusion that the Euro will survive, if only because the alternative is a worse option for its constituents.

The Economy

Europe is most likely already in a recession and the austerity cuts are still in the early stages of implementation. Eurozone unemployment now stands at 10.3%, with the rate in the U.K. rising to the highest level it has been in sixteen years (8.4%). As government cost cutting continues, the situation will probably get worse before stabilizing.

Outside of Europe, the economic outlook is mixed. The World Bank is predicting a turbulent year ahead and just cut its global economic forecast to 2.5% (down from 3.6%). Growth rates in emerging markets have slowed and the BRIC countries are grappling with inflation, lower export growth and higher wages. China's construction market also seems to be cooling, which is another ominous sign.

Closer to home, the Canadian economy seems to be falling back to earth after a long period of outperforming the U.S. Domestic bank CEOs warn that Canada's housing market is looking increasingly risky, as the level of household debt reaches record highs. The recent rise in unemployment, coupled with government budget cuts, will add further pressure and dampen growth.

On a positive note, the U.S., which led the world into recession, is showing tangible signs of improvement, albeit at a far slower pace than past recoveries. Recent data points relating to U.S. housing, employment and durable goods have been somewhat inconsistent, but the trend is encouraging.

Against this backdrop, central banks will continue to make life difficult for bond investors by keeping interest rates artificially low. Investors in government bonds in Canada and the U.S. will earn next to nothing on their money. **Adjusted for inflation, government bonds and GICs now have a negative real return.**

As of December 31, 2011	
5 year Canada Government bonds	1.28%
5 year U.S. Government bonds	0.83%
Canada inflation rate	**2.3%**
U.S inflation rate	**3.0%**

Faced with such low yields, those living off their investments are faced with a conundrum – invest in high quality bonds and GICs and deplete capital, or shift into dividend paying stocks and hope that they maintain their value.

There is an alternative, however: high yield bonds. It is an area in the market that has been growing in Canada along with investor appetite for increased yield. While it still in its infancy, the burgeoning high yield bond market in Canada has grown rapidly to over $10 billion. The market is still very small, compared to that of the U.S., but it is has been growing quickly as investors try to deal with inadequate government bond rates. (For more information, visit: http://steinbergwealth.com/aspx/m/1132782)

Bad news creates great opportunities

All of the bad news last year created many opportunities for us to spend some of our cash. Here is a chart of a number of our investments.

Company	Price Paid	5-yr High
Royal Dutch Shell	$49	$87.40
Sun Life	$24	$55.58
Futaba	1316 yen	3,250 yen
Manulife	$12	$42.98
Morgan Stanley	$15.80	$73.26
J.C. Penny	$19.50	$85.25
Philips	$16.60	$45.41
Topre	636 yen	1295 yen

The theme is simple: take a look at the 5 year high of these shares. Now look at the price we paid. We do not need any of the high quality companies listed above to reach their highs again for us to do well. In fact, with the relatively high dividend yields we are receiving, we do not need much to go right to earn an attractive return.

Intuitively, we all know that the way to invest successfully is to buy strong businesses at depressed prices, not at their highs. Yet behavioural finance explains that investors tend to do the opposite - buy what is doing well and that has gone up and avoid anything that has fallen.

Value is the key

“If you buy a dollar bill for 60 cents, it's riskier than if you buy a dollar bill for 40 cents, but the expectation of reward is greater in the latter case. The greater the potential for reward in the value portfolio, the less risk there is.” -Warren Buffett

Our research effort is focused on finding deep value in places that others have overlooked. When everyone is buying the same thing, not only do the risks become greater, but much of the upside is already priced in.

As we have mentioned throughout the year, it is this search for value that has led us to Japan, where a vast number of great companies trade at incredibly steep discounts to their intrinsic value. Where else can one find consistently profitable, dividend-paying companies with long histories, no debt, sound financials, strong market share and competitive positioning that **trade for less than net cash or liquidation value?**

The question we are sometimes asked is: will this value ever get realized by shareholders, or will these companies stay cheap forever? The truth is that no one can accurately predict when value will get realized. Irrationally priced assets can stay irrationally priced for long periods of time, but ultimately, they will reflect “economic reality.” Simply put, if a company remains absurdly cheap for too long, it will eventually get bought out. That is what we have started to see happen to several similar companies in Japan (such as Sanjo Machine Works and Aloka Corp., which were acquired last year for over 100% premiums).

However, in order to take advantage of these “irrational” prices in the marketplace, one must have patience and a long-term orientation. Unfortunately, most investors are plagued by short memories and desire fast, short-term returns – something the casino industry understands all too well.

Conclusion

With the many risks that exist in the market and a sluggish economy being the best case scenario, we anticipate ongoing volatility and remain focused on searching for securities that meet both our strict financial quality criteria and trade at compelling valuations. We continue to be armed with a large cash position to take advantage of the swings.

Investors have suffered poor returns since 2000 and the message throughout history has always been the same. Buying what everyone else is buying, or what is on the front page of newspapers, is not a good recipe for successful investing. The best way to earn excellent returns, while minimizing risk, is to buy strong companies when they are out of favour and their shares are trading at “irrational” prices -- the road not taken by most investors.

Sincerely yours,

Lorne Steinberg

Creating Value.