January 2013

"If you're not confused, you're not paying attention"
-Tom Peters

Navigating in Uncharted Waters – Avoiding the Rocks

Dear Client,

The New Year is often a time for reflection, a chance to take a step back from the day-to-day issues we all deal with and take some time to look at the "big picture". I have always worked throughout the holiday season because, while most of the world is on vacation, the peace and quiet in the office affords time and space to reflect on the year that has passed and to set our course for the year ahead.

The year ended on a positive note. The U.S. did not fall over the "fiscal cliff"; the Euro region muddled through; markets rallied in response to fresh stimulus from the Fed; China has thus far avoided a "hard landing"; and the election of a new government in Japan has attracted investor interest.

That being said, investors have been lulled into a sense of complacency by assuming that central banks will keep pumping money into the system until things return to "normal". This has helped drive riskier asset prices higher. However, there is growing consensus that monetary stimulus may begin to unwind later this year (the minutes from the most recent Fed's Open Market Committee point to changes on the horizon). If so, investors who are relying on Ben Bernanke to save them may wish to revisit their strategy.

When the Fed starts withdrawing stimulus, interest rates will almost certainly start to rise and investor sentiment may quickly change.

We are in uncharted waters.

The facts today

On January 15th, the World Bank reduced its forecast for global growth in 2013 to 2.4%, roughly the same rate as 2012. The good news is that the world economy is still growing. The bad news is that the growth rate remains below what is required to get employment back to pre-financial crisis levels. It is now five years since the crisis began and, despite trillions of dollars of central bank stimulus, the hangover remains.

Europe is projected to stay in recession this year. U.S. growth is projected to slow to 1.5%, due in part to the return of higher payroll taxes. Canada is unlikely to fare much better, with the housing market poised for a decline. Emerging markets continue to be the bright spot, albeit with growth at a slower pace than most of the past decade.

As mentioned earlier, global markets are being supported by unconventional central bank policies aimed at encouraging investors to take on risk. This usually refers to QE (quantitative easing, which essentially means "printing money") which takes the form of large-scale central bank purchases of government and mortgage bonds. In the U.S., this has been referred to as the "Bernanke put" because Ben Bernanke, the head of the US Federal Reserve Board, has been using QE to support markets and boost investor confidence. Thus far, he has succeeded, as home prices, equities and bonds have all been on the rise.

However, investors must ask themselves the following questions: Is it rational to assume that the U.S. government can continue to run large deficits at little or no cost? Will QE lead to elevated levels of inflation? Will the Fed be able to successfully withdraw stimulus without causing a recession and/or steep rise in long-term interest rates? Is another bubble building that will lead to investor pain?

Does all of this imply that the recent policies are misguided? No, but the implications of these policies are unknown.

Bond bubble?

One of the root causes of the financial crisis and housing collapse was *easy money*. Borrowers were lured by low rates and loose monetary policy to take on excessive debt and acquire risky assets – we all know how that turned out. The wounds from the financial crisis have not fully healed and we are still dealing with the aftermath, yet investors are beginning to exhibit signs of amnesia – stretching for yield without regard for underlying value.

U.S. 10-year and 30-year Treasury bonds yield 1.8% and 3.0%, respectively. In the context of heightened inflation risk, these yields do not adequately compensate investors. ***Holders of long-term bonds and/or investment grade bond funds may suffer steep losses when the Fed stops supporting the market***. After a 30-year bull market for bonds, investors seem to have forgotten that the long-end of the market is extremely sensitive to relatively small moves in interest rates. While the jury is out as to whether the bond market is in bubble territory, one thing is clear: unless the world falls into recession, there is zero value left to be squeezed out of these securities.

Investment strategy - hunt for value

While seeking to avoid the rocks in charting our course, we have made several investments over the past quarter, all of which meet our strict criteria for quality and value.

The most controversial of these is Hewlett Packard and we will explain our rationale below.

Hewlett Packard

In transitioning away from manufacturing PCs, Hewlett Packard has been plagued by management mishaps over the past several years. Earnings have suffered and its shares now trade close to an 10-year low. PC sales have been softening and there is no denying that HP faces some daunting challenges in the years ahead.

The best time to look at great companies is when they stumble and are out of favor. We believe the pendulum has swung too far and that investors are overreacting. The company is in solid financial shape. It has a strong market presence in IT services, imaging and servers, and should be able to return to growth by 2014 as Windows 8 gains traction on touch-based devices (such as tablets and convertible/hybrid laptops). We believe that its IT services business alone is worth the current share price and estimate a total break-up value exceeding $35. Its shares are significantly undervalued and offer a 3.5% dividend yield based on our purchase price.

Japan - an inflection point?

We have been buying Japanese shares since 2009 on the basis that there is no other market in the world offering such compelling value. While we have been earning good dividend yields, the market has remained out of favour... perhaps until now.

In December, Japan's new prime minister Shinzo Abe was elected to office on a pro-growth platform. He is in favour of U.S.-style monetary policies to stimulate growth. It is too early to know to what extent this program will be implemented and what impact it will have. The yen has undergone a major correction in anticipation of the new policy direction, which, if sustained, will boost exports and corporate earnings. The Japanese market has suddenly rallied, catching the attention of foreign investors.

The companies we own in Japan all share the following characteristics: they are financially sound, have minimal debt, long successful operating histories, and, most importantly, are trading at a steep discount to intrinsic value. When buying great companies for less than their *net cash* or *net working capital*, the risk to capital is low and the return potential is substantial. We never concerned ourselves with the timing of these investments, as the catalysts that make stock prices converge with a company's economic reality are impossible to forecast. What is required, as is the case with any value investment, is a great deal of patience.

High Yield Fund

The High Yield Fund performed well in 2012, while sticking to its conservative mandate.

The high yield bond market continues to offer investors a significant yield advantage versus investment grade bonds. Most of these issuers are in good financial shape and have reduced their interest expense by refinancing in this low rate environment. The biggest risk to investment grade bonds is rising rates. Counter-intuitively, the high yield bond market is far less sensitive to interest rates because of its wide spread over government bonds. Despite this, given the various macro risks that exist, we are maintaining a short duration portfolio. We are comfortable giving up some yield in order to preserve capital should there be some negative surprises along the way.

More information on our funds is available [here](#).

Final Thoughts - looking down before looking up

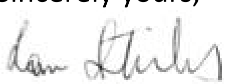
Global austerity is stifling growth as governments strive to reduce deficits. The only tool left to stimulate growth is for central banks to continue “printing money”. Some of the brightest economic minds of our generation disagree on the appropriateness of this action and the potential consequences, which may include a spike in inflation. Suffice to say, we are in uncharted waters.

The only way to successfully navigate, as investment managers, is to manage every investment with an eye to the downside and to ask questions such as “will I generate an acceptable return over the next several years if interest rates or inflation rise more than forecast?” If we believe the answer is yes, then we go ahead with investments like Hewlett Packard, where the potential upside far outweighs the risks. If not, then we refrain and sit on our cash until the next compelling opportunity arises.

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

All of us here at LSWM wish you and your family peace and health for the New Year.

Sincerely yours,



Lorne Steinberg
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