THE NEW NORMAL – IT'S THE OLD NORMAL

We continue to read opinions of some economists and strategists that we should not expect a normal recovery. That we are entering a different kind of period. A new normal. For the U.S., from trillion-dollar deficits, deleveraging consumers, housing and banking sectors that could take years to recover, a weakening currency, potential for deflation, or hyperinflation.

Bill Gross and his colleagues at PIMCO, the largest bond investment fund in the world, believe we are into a new normal—persistent U.S. joblessness, slower than expected economic growth with structural problems that the government will continue to need to address. And that investors should expect lower returns than the historical average. Although, in the meantime, PIMCO is getting into the equity business, because equities offer more promise than bonds in a rising rate scenario.

The bearish economists, Roubini and Rosenberg, Dr. Doom and Dr. Gloom, tell us the economy could weaken again, a double dip, that the market is overvalued and that all we've had since March '09 is a bear market rally. On the other hand, Jim Paulsen, Chief Investment Strategist at Wells Capital Management, recently noted that the pace of real U.S. GDP growth two quarters into this recovery is actually ahead of the pace coming out of the 1981-82 recession and only slightly behind the pace of the 1975 recovery. More important, because inventory liquidation played a big role in the 1981-82 recession, as in this one, the subsequent restocking effect propelled real GDP growth for many quarters after the recovery began. And, noted economist, Brian Wesbury, predicts the U.S. economy will grow at least 4% this year stimulated by all the liquidity. In his view, the equity market is undervalued by one-third and a shortage of housing is looming.

We are not economists. All that crystal ball gazing. Our task is easier. Merely to buy good, undervalued businesses and wait for them to be revalued to their normal Fair Market Values. And, importantly, we believe that the market is significantly undervalued, with earnings continuing to surprise on the upside as will the stock market. Dr. Boom. Or maybe even, Dr. Zoom.

Simple Arithmetic

To be sure, we need to have opinions about the bigger picture too—interest rates, inflation, consumer sentiment and buying power and the like—because they impact the variables which make stocks and bonds attractive, or not. Those variables which affect the attractiveness of equities as an asset class are corporate earnings, the prospects for their growth, balance sheet strength, current and prospective interest rates (because bonds compete with stocks and companies use leverage to grow), the cash available to invest in equities (the potential "demand", so to speak) and their valuation (the potential future return from current share prices relative to Fair Market Value).

To be sure, it's always a challenge finding the right stocks. Then too, we also want to "time" our purchases and sales, waiting for the right buy and sell inflection points based on our SVA™ work and market technicals. We may like them but we always try to optimize our entry and exit points.

While economists mostly predict, we mostly react. And select. We're like the judges at American Idol. Lots of pretty faces but we're into the quality performers. The Susan Boyles. Yes, we know, she was on Britain's Got Talent.

Bad News Is Good News

If it is earnings and interest rates which are the important drivers of the attractiveness of equities versus other asset classes, we may be in an almost perfect storm—a welcome storm. In this case bad news is good news. While unemployment seems to have stopped growing, the U.S. unemployment rate for December dropping slightly to 9.7%, it is still coming down too slowly for this stage of economic recovery. But while that may concern voters and politicians, it should conversely satisfy investors, including the skeptics, that it will keep productivity high (union demands weaker, available labour plentiful) and inhibit the Fed from raising rates soon. Better productivity means lower costs and better profit margins. Obviously, excessive unemployment dampens consumer demand, but consumer sentiment has in fact risen recently and consumers have been deleveraging, repairing their ability for future spending, and their savings rate has risen to almost 5%.

Money Makes The World Go Around

Nervous investors, deleveraging consumers and cautious corporations have been piling up liquidity. Cash on the sidelines is at a multi-decade high, some $10 trillion for households and companies, with households alone holding some $7.7 trillion in liquid assets. Fuel for consumer spending, for investing in what investors for the moment believe are riskier assets—equities, and, as for companies, fuel for business expansion, capital spending, acquisitions and share buybacks. All good for profits and for share prices.

And while the yield curve from the 10-year to the 30-year is relatively flat, only 90 basis points for 20 years of inflation risk, the yield curve in the short end is the steepest in history with Fed funds essentially at zero. While the U.S. administration intends to limit some risky trading activities of banks, and with the Fed having just raised the discount rate (to 0.75% from 0.50%—getting back to "normal"), and with the demand for credit still weak, the backdrop for the profitability of Financials as an equity category is still very favourable. Banks are still able to borrow cheaply to buy U.S. treasuries up the curve for a significant risk-free return, with an even healthier potential return lending to their regular customers. Loan loss provisioning going forward for Financials should be lower, boosting their bottom lines too.

Global manufacturing activity accelerated to its fastest pace in nearly four years during December. Q4 U.S. GDP rose 5.7% which, even adjusted for inventories, was respectable and the consensus outlook is for about 3% GDP growth for 2010. Inventories relative to sales are at an 18-year low and will need to be replenished from higher production domestically and by boosting imports which will help global production.

Housing in the U.S. continues to be very affordable with 30-year tax-deductible first mortgages at around 5%. And a first-time buyers tax credit to April 30th. Housing inventories are declining and prices stabilizing. Retailers are doing better, with Ford and GM leading the way for autos. Even after "cash for clunkers" expired, avoiding Toyota "clunkers" is helping the others. Restaurants are improving too. More stimulus could be coming. $30 billion for small businesses to encourage hiring. Shoppers are flocking to discounters, so discount retailer Dollar General intends to add 5,000 jobs as it opens 600 new stores in the next 12 months. The new normal clearly isn't all bad. Corporations have generally confronted the slowdown well, strengthening their balance sheets, making themselves more efficient and looking for opportunities to grow.

Earnings Normalizing

Corporate earnings for the S&P 500 for '09 were 30% below their '07 peak but are on their way to normalizing, perhaps getting back to the '07 level by '12. Top down and bottom up estimates for S&P 500 earnings for 2010 are in the high $70s and as such the S&P trades at only about 14x earnings with a Fair Market Value of about 1300, some 17% higher than the current price. Earnings growth should continue with S&P earnings likely growing 10% or more per year for '11 and '12. We think, based on current low interest rates which should continue for the near future and the prospects for growth in earnings, the price/earnings ratio should be closer to 16.5x giving the market a three-year appreciation potential of around 11% per year (including dividends).

The total return index levels (including reinvestment of dividends) for the Dow Jones Industrial Average and S&P 500, both proxies for large cap stocks, are lower than they were 10 years ago. A lost decade. Notwithstanding our disastrous '08 performance ('07 and '08 being the only down years for our equity composites in the last 10 years), the 10-year annualized returns at December 31, 2009 for our Long-Only Composite is 11.3% (15% in US$, translated from CDN$) and for our Long/Short Composite is 13.5% (17.2% in US$), all after fees. Over that "lost decade" for the major averages, our Canadian clients tripled their original investment in the decade and our U.S. clients, from the currency effect, quadrupled theirs. But understandably, we now suffer a lost half-decade, and for clients who came aboard in the last 5 years, our long-term record is no

solace. Obviously when you incur a large loss you need a larger gain to recover. We have had a significant recovery since the March '09 lows, and we have a great amount of confidence in the makeup of our current portfolios. Hopefully, over the next 5 years, as our recovery continues, '08 will become a distant bad memory.

The New Normal – A Bond Bubble

Interestingly, even though we claim that equities are by far the preferred asset class, understandably nervous investors still prefer fixed income as they recently continued to move from U.S. equity mutual funds into bond funds (or, worse still, money market funds and savings accounts, where they earn nothing). In fact, government and high-grade corporate bonds may be the new bubble. In '09, $35 billion left U.S. equity funds while $421 billion fled into bond funds. Yet, in our view, bonds are really the riskier asset class, 5-year U.S. treasuries yielding a meager 2.5% and the 10-year and 30-year treasuries only 3.8% and 4.7%, respectively. For taxable investors, a far less favourable potential after-tax return than on equities. And, how about that the 3.3% dividend alone, on our favourite safe-dependable stock, Clorox, approximates the return on the 10-year treasury? Yet undervalued Clorox has the odds-on added potential to meaningfully increase its share price to its growing Fair Market Value.

In the meantime, in that lost decade for equities, 10-year U.S treasuries outperformed equities, returning just over 6% per year over the 10-year period. Remember a few years ago when everyone loved houses and stocks. Now they love bonds. Equities after the rally are only 27% of U.S. household financial assets compared to 44% at the peak in 2000. But the tide is turning. As the global economies recover, interest rates will rise ending the 28-year bull market in bonds. The baton is being handed to equities. And maybe houses too. Ah, the old normal.

If, for stock investors, bad news is good news, then the converse must be true. Consumer spending forecasts will continue to improve, employment growth will commence reinforcing consumer confidence and spending, businesses will increase capital spending and hiring of personnel, all good news and all leading to what Mr. Bernanke is planning, Fed tightening, "normalization" of Fed lending—a negative for bonds and a restraint on stocks. Needless to say, as bottom-up stock pickers, we will continue to look for undervalued ideas when the going gets tougher. There's always a bull market somewhere.

The Buck Stops Here

One of the wild cards that is obviously influential on the economic recovery, but has become unduly influential on stock, bond and commodity prices, is the direction of the U.S. dollar. Clearly a lower dollar benefits U.S. exports (which President Obama has pledged to double over the next 5 years), and U.S. multinationals who can sell more abroad, receiving an earnings boost from the beneficial translation of foreign earnings into their U.S. reported numbers. Nearly half of revenues for S&P 500 firms comes from abroad. Not to mention that a lower dollar would help lower the U.S. trade and current account deficits. The U.S. trade deficit for January rose to $40.2 billion and is on its way up. For all those reasons we believe the U.S. can't want a higher dollar. But, all other countries want their currencies lower too, for the same reasons. The recent strength of the U.S. dollar, despite proposed government spending of 30% of GDP

(up from a normal 20%) giving rise to a record budget deficit of $1.6 trillion—a whopping 11% of GDP (compared to 1.8% in '07, and compared to France's 7%, Italy's 6%, and Germany's 4%) and despite a potential U.S. debt downgrade of its AAA status, has to do with the flight to the U.S. dollar as the reserve currency from the problems in Euroland—Greece, Portugal, Spain and Italy. Clearly, the lesser of evils. But the Europeans are likely dealing with the issues. And, don't think the major exporting countries of Europe—Germany, France and Italy—aren't happy to have the low Euro make them competitive in order to sell more BMWs (up 16.6% in January), Cotes du Rhones and Ferragamos. Problem is, when interest rates everywhere are near zero, no Central Bank has room to lower rates to make its currency less attractive. Hello Greece.

Now, recently, we've been getting U.S. dollar knee jerk reactions. Emphasize "jerk". Whenever the dollar strengthens, stocks and commodities sell off and when it weakens, they rally. Everywhere. So if we believe the U.S. dollar shouldn't be allowed to strengthen that should be supportive of what we're invested in. Oh, and by the by, you'd better believe the Democrats want a higher stock market to help their sagging popularity. And, another positive, Washington in gridlock may be able to do less to impede a normalizing recovery.

The U.S. needs to borrow to cover its huge deficits. Mainly from foreigners and mainly from those with whom it runs huge export deficits, such as China and Japan. But, with the inevitability for higher interest rates and the possibility of a lower dollar, foreign lenders may be wary of their U.S. debt purchases. One failed treasury bond auction, requiring the Fed to be the buyer of last resort, will exacerbate a dollar decline, have inflationary implications and drive interest rates higher. Bad for bonds. Better for stocks than bonds. Good for commodities. And commodity stocks. Great for gold.

The Old Normal – Cheap Small Caps

We view the recent 8% market decline as merely a correction. The markets were overbought in early January and due for a pause. We still have green lights in our SVA™ work. The large cap indexes remain "on buy" in our SVA™ work and trade around 85¢ on-the-value-dollar. With the decline, the overbought levels quickly turned to oversold, and the number of bears outnumbered the number of bulls, reestablishing a base from which the markets could once again begin to rise.

While the larger cap indexes are back within 25%-30% of their '07 highs, the smaller cap indexes are still much further away from their highs—the S&P/TSX Venture Exchange Index, for example, still 55% below its previous high. That's not unexpected inasmuch as the Venture Index plummeted 80% during the Panic from its high in '07.

So, while stocks in general are still reverting to their fair values, smaller stocks, in particular, still have a long way to climb back. A bigger potential upside encouraging us to remain overweight in smaller cap holdings. We continue to be willing to trade off liquidity for the much higher potential returns offered by these holdings. Most of our small cap holdings are in the resource area, particularly oil and gas, where their inordinate opportunity for organic growth should be

augmented by higher commodity prices. Specifically, by dollar weightings, Corridor, St Andrew and Orca represent most of our holdings in this area.

Corridor Resources continues to be, by far, our largest individual holding and its return potential continues to improve. Debt free, producing premium gas and advantageously located in New Brunswick, close to the best North American market, Corridor has had several significant positive developments over the last few months. Its first two wells fractured with a new propane technique materially increased initial flow rates. While those rates have since declined much more than expected, there is a real potential to enhance returns on each new well drilled.

In September, Corridor's independent consultants estimated the shale gas potential in the lower Frederick Brook formation at a mammoth net 59.1 TCF of gas-in-place. Then the company announced drill results from its first two wells specifically targeting the shale zone where they had hit substantial initial flow rates on both wells. On the heels of that, Apache (a major U.S. oil and gas company) partnered with Corridor to spend $25 million by June of '11 with an option thereafter to spend a further $100 million on development, with Corridor still retaining over 60% of its Frederick Brook shale zones.

Though the share price doubled since November, it recently corrected with the overall market and the natural gas stocks generally, but is still up about 50% from November and now in line with the net asset value from its existing known reserves. Based on cash flow prospects from its conventional Hiram Brook proven and probable reserves, Corridor remains undervalued. More important, the stock price has yet to reflect: (a) the value of the massive shale play from the Frederick Brook formation which Apache will now help delineate, (b) a 2 billion barrel potential oil prospect in the Laurentian Gulf ("Old Harry") where the company may also soon find a partner to begin drilling this prospect in '11, (c) the potentially valuable Salt Springs gas storage facility, (d) its PEI prospects, (e) its Anticosti Island prospects and (f) the potential for higher natural gas prices. Our risk adjusted Net Asset Value is $10 today and our 3-year target is $16 offering a potential annualized 50% rate of return.

Our weighting in *St Andrew Goldfields* continues to be high not because we've necessarily added to the position but because its share price is up significantly from its '09 low and, commensurate with the improvement in its operations, it has held up near its 52-week high despite the recent correction in the price of gold and gold stocks generally. After commencing production in October it produced over 18,000 ounces in Q4 '09 and ended the year with $16 million in cash and 4,000 ounces of gold on hand. The company is forecasting 85,000 ounces of production for '10 and 120,000 ounces for '11. Its balance sheet will continue to improve as it pays down debt from cash flow sheltered by its significant tax loss pools.

It recently released drill results from its Smoke Deep zone (with 15 of 17 holes intersecting gold mineralization) which is similar to the Lightning zone from which 1 million ounces have been produced. There are a number of similar targets east of the Blacktop zone where it is currently producing. St Andrew has yet to have an analyst research report but is starting to come onto investor radar screens as it is recognized as a well-managed, safe, production and exploration story. St Andrew offers a return potential of nearly 30% per year over the next 3 years without any assumptions for material exploration success.

Orca Exploration still trades at less than one-third of its growing $11 net asset value. Debt free, growing and safe. We expect natural gas demand for power from power-starved Tanzania to begin to drive cash flows much higher over the next few quarters. The company has the capacity to meet an average gas demand of 160 mmcf/d (including 40 mmcf/d of protected gas which flows to the Tanzanian power utility) with power and industrial consumption just beginning to ramp up. The company is currently limited to 90 mmcf/d though we expect that to be raised over time as new facilities come on stream. Cash flows are expected to approach $1 per share in '10 and $2 per share by '12. Acquisitions sought in the Middle East and Africa may also add to growth. Also, there is a strong possibility of disposition of the Tanzanian assets over the next couple of years at multiples of the current share price. Our 3-year target is $14, providing a potential 57% annualized rate of return.

Ruby Tuesday trades at only 6x free cash flow. With the equity raise of last summer and the free cash flow it generates, the company is closer to being able to enhance shareholder value via dividends and/or share repurchases. Restaurant traffic growth is positive again and margins should begin to lift. Our target is $18 in three years for a prospective 30% per year return.

Petrolifera Petroleum has now reentered the La Pinta 1X exploration well in Colombia and is drilling another well nearby. The lower zone of the La Pinta 1X well again encountered technical problems; therefore, it will be plugged and a test of the upper zone will commence. Petrolifera farmed out a small portion of their Argentinian assets and further drilling has added to production in Argentina. We continue to wait for a partnership agreement on its vast Peruvian properties. All this justifies a value today of more than 3 times the current share price.

Malaga's tungsten production has now risen to about 375 t/d from 250 t/d and is on schedule to be at 500 t/d by mid-'10. At that point it should be worth more than 3 times the current share price. And, the cash flow from increasing production should drive the valuation even higher with the wherewithal to drill off part of 25 major structures within the 77 known tungsten veins. To boot, tungsten prices have strengthened and the company has a plan to generate additional revenues from its silver and copper off-take and from a hydroelectric plant.

TG World Energy is now drilling on both development and exploration prospects in Alaska, results from which could be material. The company still trades for less than its cash (including Alaskan tax credits) alone, and that cash plus our conservative appraisal of TG's oil and gas assets adds up to a total value nearly 3 times more than its current share price.

The New Normal – Abnormally Cheap Large Caps

Generally, our 3-year targets for the smaller cap companies we hold continue to imply potential annualized returns above 40%. So small caps are still very attractive. But, the FMV of big caps has continued to grow even as their prices have been held back from the Panic, creating an abnormal disparity between price and value. The unusual return opportunity from our big caps is more than 25% per year over the next couple of years. And, some, including, Clorox, Kroger and CVS Caremark (all safe-dependables), should continue to grow even if the economy weakens. And, though they throw off a lesser potential return than from our small caps, they provide the liquidity which small caps were denied in the '08 and early '09 meltdown and,

importantly, allow us to trade them using our SVA™ work. If the value we are finding in Consumer Staples, the so-called safe-dependables, is the New Normal, well, we can't get enough of this "normal".

Clorox has compounded its fair market value growth by about 10% per year over the last decade, even growing through the recent recession. At 13x earnings, it trades at a discount to the overall market whereas the company, over the years, has *normally* traded at a significant premium. An attractive price, a 25% discount to its FMV—for a company that sells products that are essentially recession-proof consumer staples—everyday use products which must be replaced—brands like Clorox bleach, Ajax, Liquid-Plumr, ArmorAll, Pine-Sol, Glad, Brita and Burt's Bees. And how about that its dividend—a dividend that has regularly increased for 32 years—currently yields slightly more than Clorox's own 5-year bonds.

Clorox is worth over $80 today, ought to be worth over $90 in a year and nearly $100 in two years—a 2-year potential return of over 30% per year (including dividends). The market is *normally* efficient and Clorox normally trades very close to its FMV, but, the inefficiencies created from the Panic have left Clorox at bargain levels. And the same for Kroger and CVS.

Kroger, the largest and best run U.S. grocer stands to benefit from higher food costs and the lower unemployment we expect over time, though we still anticipate an earnings lift over the next couple of years even with minimal inflation and little improvement in employment. Kroger's FMV is expected to be around $36 in two years for a potential 29% annualized rate of return (including dividends).

CVS also offers a high 26% potential 2-year annualized rate of return. The company continues to add stores, increase same-store sales, cut costs and generate meaningful amounts of free cash flow which can be used to fund additional share repurchases. The pharmacy side of the business has been extremely stable and the pharmacy benefit-management division should begin to show similar stability. Clorox, Kroger and CVS—high quality businesses selling at below market multiples and far below their FMVs.

Normal Additions

We recently added Jack in the Box, GameStop and Goldman Sachs Group.

Jack in the Box operates a hamburger chain of some 2,200 locations and over 500 Qdoba Mexican Grill restaurants. We were able to buy the shares at an attractive price (about 10x earnings) because of recent same-store sales weakness attributable to its exposure to the weak California market. We chose to look beyond this recently reported sales weakness given Jack's proven management team, brand history and successful track record of menu innovation.

Jack in the Box's value is derived from three segments. First, it has a major refranchising initiative—selling owned stores to franchisees—which provides immediate cash flows from asset sales. It is currently 50% franchised but by '13 should be over 80% franchised (McDonald's and Burger King are approximately 90% franchised). Restaurant locations are selling above our estimate and franchisees are not having financing difficulties which bolsters our confidence in the brand. Franchising should fuel future operating margins as the business evolves into more of

a royalty business and return on invested capital could jump to over 20% from today's 12%, translating, we expect, into a higher earnings multiple. The present value of this segment is $7/share. Qdoba, the company's second segment, could be spun-out entirely and using comparable public company valuations, Qdoba is worth about $3/share. We value the remaining hamburger chain at about $20/share. The sum of the parts yields $30 today with growth ahead, from major cost savings, with even more upside if same store sales rebound, asset sales occur more quickly or share buybacks are pursued more aggressively. Our 2-year FMV return potential estimate is about $42 or 39% per year.

Recent investor sentiment towards the video game group and specifically to *GameStop* has been negative. The combination of the digital threat and near term sales weakness driven by a weak software release schedule and console price cuts have put a damper on the group. However, there are favourable longer term trends in the video game market. The perceived risk over online distribution has created an opportunity in GameStop, the world's largest retailer of video games and video game accessories, pushing the shares down to only 7x earnings. The company operates a high barrier-to-entry and extremely sustainable used game segment, which represents approximately 45% of operating profit. Used game and console sales should not be affected by digital distribution for many years. We are also attracted to the highly productive stores GameStop operates, a product of their enthusiastic, service oriented and game-centric employees.

Thanks to its aggressive share buyback plan, roughly 10% of the outstanding shares should be retired in the next few quarters. GameStop should generate nearly $4 per share in free cash flow over the next 24 months. Digital distribution should not begin to negatively affect GameStop before '14 and by then GameStop may have retired 50% of its current outstanding shares. We have run various doomsday scenarios to stress GameStop's future free cash flow, and under these dire scenarios, we still get to a current net asset value 80% above today's share price. Applying a modest multiple, we arrive at a fair market value for the company in the $30s today, rising to the low-$40s in the next 2 years for an estimated 2-year annualized potential return of around 50% per year.

We also initiated a position in *Goldman Sachs*, arguably the world's preeminent investment bank. The uncertainty in the U.S. banking sector created an opportunity to buy Goldman at only 8x earnings. Standing shoulder-to-shoulder, President Obama and Paul Volcker, former Fed Chairman, announced their intention to restrict banks from proprietary trading, hedge fund management and other activities unrelated to servicing clients. Goldman shares promptly dropped nearly 20% in two weeks. We concluded that eliminating Goldman's "prop" business (6%-10% of revenues) at most would reduce next year's earnings per share to $17 (all else equal) compared to the current consensus '11 estimate of $20.55. The Volcker plan could present an opportunity for Goldman to spin off its non-client servicing units, leading to a higher multiple for its underappreciated stand-alone banking franchise. Or, Goldman could merely allow more transparency to the market and government.

Either way, we see little downside from its current pricing at only 8x earnings and 1.2x book value (median historical multiples are 12x and 1.8x, respectively). As the global economy recovers, Goldman is ideally positioned to benefit from increasing M&A activity, trading and financial transactions. With many of its competitors still regrouping after the '08 financial panic, its competitive position is better than ever. Our fair market value is $220 per share or 40% higher than the current share price and its 2-year potential rate of return to fair value is 34% per year.

After adding slightly to our *Aetna* position recently, we then reduced the weighting when it promptly gave us an SVA™ sell signal. We still believe Aetna is the best run national health insurer with the best plan designs and top underwriting standards. At 10x 2010 free cash flow, compared to our 14x fair market value assessment, we still believe the stock has excellent longer term prospects. And, we still expect at least 7% operating margins or $4 of annual earnings per share in 3 years. We expect Aetna to grow its FMV to the high-$60s in that 3 years for a potential 34% annualized rate of return. We are now waiting for the opportunity to buy back the shares we sold whenever our SVA™ work gives the buy signal.

We continually monitor a universe of undervalued big caps to add whenever they reach their "floors"—buy points in our work. For clients who have recently contributed new funds we have also added *Johnson & Johnson*, *Burger King*, *Gilead Sciences*, *Wal-Mart* and *Home Capital*—all with prospective annualized 2-year returns above 20%. For clients who held them, we recently sold *Becton-Dickinson* after its run up toward FMV, its ceiling in our work, and *Berkshire Hathaway* for similar reasons after it was added to the S&P 500.

Short Sale Activities

We covered our Palm short as it approached our target, falling to $12. We recently added two additional short positions, Potash Corporation and BJ's Restaurants. Both the Agriculture group and the Restaurant sector have given sell signals, and Potash and BJ's were the most overvalued stocks in their respective groups.

With the markets now "on buy" we want to minimize our short exposure. Naturally, if the markets rise to ceilings or to fair value we will certainly look to add to our short exposure.

Income Accounts In The New Normal

We make the point again, that income investors should be wary of bonds. Some very savvy bond investors worry that all the dollars sloshing around the U.S. economy, with the exploding monetary base, can only have an inflationary outcome. Bad for bond investors. Bad for the dollar. And we make the point again, from our last letter, that with the inordinately low yields currently available on fixed income securities, a preferable alternative for accounts seeking lower risk investments could be an equity component of the defensive, safe-dependable stocks that are now unusual bargains—growing blue chip companies at 75¢, or less, on-the-value-dollar. And we emphasize again the important tax implications for taxable accounts. Bonds yielding 4%-6% leave an investor with a paltry 2%-4% after-tax, versus profits on stocks which are subject to capital gains taxes rather than income taxes, with nearly 80% of the gain as an after-tax return.

In other words, the after-tax return on, say Clorox, could be over 20% per year over the next 2 or 3 years, well above the meager after-tax return that can be earned safely on bonds. Plus a meaningful dividend to boot.

Our income portfolios have a current income yield of about 8% per year. With that current income and our anticipated capital gains, over the next 2 years we expect a potential total return of over 15% per year.

Specialty Foods Group earnings have been beyond our expectations and the company now has a considerable cash hoard relative to the debentures we hold—the only debt outstanding.

With commercial production having commenced in October and production ahead of expectations for the last quarter, we expect St Andrew to free cash flow enough to easily retire all our 12% debentures at maturity in December 2010 and could beat an earnings hurdle provision in the debenture triggering an extra 10% bonus payment.

We switched our *CompuCredit* 2035 bonds for the 2025 bonds which have a "put" in '12 and a yield to put of about 40% per year. The company recently initiated a tender for most of these bonds with a minimum bid price of $46 (just above our cost) but we're obviously holding for the outsized return to 2012.

Pizza Pizza Royalty Fund and high dividend paying *Student Transportation of America* both generate double-digit current yields with the added potential for meaningful capital gains as each continues to trade below fair market value.

High River Gold, is now controlled by Russian firm, Severstal Resources, with a 62% stake. The company also raised equity of $57 million to repay some debt obligations and better fund its operations. We look forward to High River paying off our bonds at par at maturity next year giving us a good gain from the $70 at which we're currently conservatively pricing the bond.

Avcorp Industries completed its financing to fund its business over the next couple of years while its larger creditors have agreed to waive interest and principal for that period. This should allow it the cash to mature our preferreds when due.

Arctic Glacier Income Fund settled its lawsuit with the U.S. Justice Department for much less than the market expected and the company just refinanced its debt lifting a major market uncertainty.

Divestco debentures were retired at year end. *Lanesborough REIT* is expected to pay off the debentures we hold, this week, from proceeds of recent asset sales and a security offering.

It’s becoming more challenging to find quality income names with high yields because bond prices have moved higher as yields in general have declined. The current yields on debt of high quality, well-known corporations are only 4%-6%. But, we continue to look at lesser known companies for better returns. There are some higher yielding, yet safe, U.S. corporate bonds which we’re now prepared to buy with the recent rise of the Canadian dollar lessening the currency risk of exposing Canadian accounts to U.S. income assets, though some hedging where feasible may mitigate the risk too.

Bottom Line – Above Normal

The economy will revive. Even the bearish prognosticators think it will *eventually*, the most pessimistic saying only another 6 years of economic misery. But we believe that U.S. GDP growth will pale in comparison to corporate earnings growth from the favourable backdrop for individual companies and from the anticipated continuing growth globally, especially from the fast growing developing economies. What investors need to realize is that all the financial stimulus has a much more material impact on stocks than on GDP. Simple arithmetic. Bill Clinton’s campaign strategist, James Carville, when referring to what matters to voters once said, “It’s the economy, stupid.” Well, as to what matters to investors, we say, “It’s corporate earnings, stupid.” We think we’re on the right track to recover smartly. Markets that decline abnormally typically have above-normal recoveries. Let’s hear it for abnormal.

Herbert Abramson and
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