SEE THE TREES

Following the ugly decline in the Panic of '08 and early '09, we confessed that we had been so focused on the trees we missed the forest. That is to say, even though we were aware of, and had written about, the macro risks from the housing bubble and the trillions of dollars in circumspect derivatives, we did not imagine the magnitude of the impact of the credit crisis.

During the stock market debacle of 2008/2009, T-bill rates actually went negative. Imagine, fearful investors, seeking safety, investing *over* $100 in T-bills to get back $100 ninety days later. Fleeing to safety, not even trusting banks with deposit insurance.

We always do, and profess to, take account of the top down factors—the “forest”—and always write about them, but we believed that our undervalued stocks, from a bottom-up basis—the “trees”—were what mattered. That investing in good businesses, trading at significant discounts from their Fair Market Values—especially when the market as a whole was not overvalued, and when other asset classes were significantly less attractive—was a sensible, even defensive, thing to do.

We got burned in '08 and early '09. Most, if not all, value investors did too. After all, the value investors’ credo is “value will out.” That is to say, abiding conviction that buying undervalued stocks will, over time, inevitably, pay off. That cheap healthy trees, over time, will inevitably vanquish troubled forests. We didn’t exactly miss the forest, we just didn’t anticipate a scorched earth forest fire.

Our short-term results suffered significantly from the '08/09 panic and the permanent impairment of a few of our small-cap selections. We plan to be more vigilant in exiting positions where risk escalates, particularly where companies incur leverage at inopportune times.

Not The Forest

Which brings us to today. Investors are so scarred and scared from having just lived through the mother of all forest fires and they are now, understandably, more focused on the forest than the trees. And admittedly it’s still a dark and unpredictable forest. Vast sovereign debt and the potential for defaults. Greece, Portugal, Spain, Italy, Ireland, the U.K.—all heavily indebted and living beyond their means. The U.S. too—19 straight months of budget deficits, with April being the largest ever recorded for an April. States and municipalities too—indeed, California and New York may be bigger problems than Greece. A bailout of Greece with austerity measures required and riots from petulant and overindulged left-wing unionists. The potential

for the end of the Euro union with the Eurocurrency under daily pressure. Might this derail the recovery? The printing of money by Central Banks to support bailouts. Might this have inflationary consequences? Might all this be contagious?

And more. The potential for increased taxes and spending cuts, or both, in order to stem runaway deficits and debt—portending the prospect for slowing economic growth. Higher U.S. taxes on capital gains and dividends may be looming when the Bush tax cuts end in January '11. Increasingly, unpopular governments in most places, including the U.S., and a minority government in the U.K., limiting its effectiveness. And in Canada too. U.S. financial reform legislation to restrain those greedy bankers. This, after healthcare legislation sure to increase debt and lower the quality of healthcare. Clearly it won't be good to be a banker or a doctor. We recommend veterinary school.

And still more. The recent "Flash Crash" in the U.S. stock market to further frighten investors about the reliability of systems, of Wall Street and equity markets. An oil spill in the Gulf that seemingly can't be contained and its consequences for further deepwater drilling and oil prices. Iranian advances towards acquiring a nuclear weapon and its consequences for world order. The sinking of a South Korean destroyer, likely by its nutty nuclear neighbour, North Korea, and the consequences for conflict in that region.

Now if, as we know, the market is a discounting mechanism, already frightened-to-death investors are discounting sovereign debt defaults, worldwide slowdown—if not depression, deflation, inflation—maybe hyperinflation, Islamic terrorism, a growingly unpopular and ineffective U.S. administration, the end of the Euro union, global warming, a ceaseless oil spill and curbs on offshore drilling, a ceaseless volcanic eruption to inhibit air travel and an invasion from Mars.

All of which, understandably, are accounting for a flight to the "risk free" reserve currency, the U.S. dollar, to the ultimate "riskless" currency, gold, and to the preference for cash and bonds over equities, no matter the former's current infinitesimal returns.

It's In The Market

The point is, "it's in the market." The '08 and early '09 Panic was, to some extent, a surprise. We didn't hear the call, "Timber!" as the forest was about to fall. Now, all we hear is "Timber!" But, to be trite, the stock market loves to climb a wall of worry. And, to be additionally trite, when the pessimism is so extreme, the news doesn't have to be good, just not as bad as generally believed.

Hey, Greece's GDP is only 3% of Euroland's GDP, about the size of Kentucky's. And there are some positives. With Greek workers' retirement age of 55 (earlier for civil servants), bonuses paid to civil servants for showing up for work on time and 8% of its GDP represented by corruption (bribery needed for hospital admission), change was seriously needed. Austerity for all those profligate European countries is needed and is good, and is now in the offing as a condition of Euro-TARP. Ireland is already making progress to reduce debt. Spain taking steps too.

The current heightened aversion to risk has created a climate where bad news is being accentuated and good news ignored. Most economic indicators are consistent with a global "V" shaped recovery, although it may be a lower case, early stage, milder recovery, "v". And with the prospects for higher interest rates and diminished government spending, the recovery may likely continue mild, but recovering nonetheless. U.S. Q1 GDP growth was a respectable 3%. Canada's, a blowout 6.1%.

Green Shoots

In the U.S. jobs are being created as depleted inventories need replenishing, manufacturing is expanding and the important auto and housing sectors continue to improve. The savings rate is rising, 3.6% for April. Wherewithal. Housing has become very affordable (U.S. housing starts up 5.8% in April) and rising income, spending and consumer confidence should continue to improve especially with rising employment as recent stats have suggested. The Canadian unemployment rate in April dropped to 8.1% from 108,700 new jobs, more than five times what was expected.

U.S. household net worth has enjoyed a $5 trillion boost from the recovery in equities since Q1 '09, offsetting the decline in housing. U.S. interest rates (and Canadian too) are at historic lows and the yield curve historically steep, a positive for earnings, especially of Financials. Despite yielding almost nothing, 10 trillion fearful dollars is currently parked on the sidelines, terrified by the dark forest. Wherewithal to ultimately spend and invest, though in the meantime being exploited by those greedy bankers, borrowing from frightened customers for zip and buying riskless treasuries.

Trees In Bloom

As for the North American stock markets, up over 60% from the March '09 lows, a correction was needed, with the scary economic events, the excuse. May was the worst month of May for the Dow Jones Industrial Average since 1940, declining 7.9%. And for the week ended May 26, the largest weekly net outflow from equity funds and equity ETFs in 20 years, $16.7 billion, and this after a $4 billion outflow the week before. Bearish sentiment usually seen at bottoms. We think that panic selling has likely exhausted the downward pressure. And that equity markets are healthier than the economy. From an investing standpoint, as the market has declined, risk has diminished as cheap good stocks got cheaper, implying less risk and improved ultimate upside. Corporate insiders, who "get" their company's prospects and valuations, have been buying aggressively.

The earnings yield on the S&P 500 is about 8% based on expected next 12 months earnings compared to 3.2% on 10-year Treasuries, a historically wide gap suggesting investors should own stocks over bonds. Forward 12-month earnings for the S&P 500 are $87, giving us a 12.6x price-to-earnings (P/E) ratio. This market is cheap relative to earnings and their growth potential, particularly, again, in light of historically low current interest rates. An agglomeration of cheap trees.

Earnings continue to surprise on the upside and many now not just from cost cutting and productivity improvements, but also from top line growth. Even from the ultimate discretionary company, Tiffany. Corporate balance sheets are strong too with well over a trillion dollars of cash on hand, a record high as a percentage of assets. Look for corporations to seriously increase dividends going forward, competition for historically low bond yields.

Most of our positions are now sitting at "floors", as is the overall market—Buy points in our SVA™ work. And because we believe the market is severely oversold, should stop going down and a rebound to begin, we are currently fully invested (even using some leverage in margin accounts) and have no short positions.

From today's attractive valuation levels, the market is much less vulnerable to market declines. The notion that this market is overvalued is simply not the case, many naysayers not even calculating the 10-year P/E correctly and misstating the trailing P/E. Our work shows the North American markets are selling at more than a 20% discount to fair value. This is corroborated by The Hays Advisory Group's historically accurate valuation model and by Value-Line's time-tested appreciation model.

P/E ratios could be impacted though, by higher inflation, and therefore higher interest rates; however, inflation does appear under control currently and P/E ratios are extremely attractive relative to historic ratios, especially compared to today's very low interest rates—rates that need to stay low to minimize their impact on growing government debt and likely to stay lowish if economic growth remains subdued.

While certain sectors of the market may still be vulnerable—consumer discretionary stocks (retailers, restaurants, autos, financials, housing, etc.) which rebounded in unison back to their fair market values—most sectors appear undervalued. And, the most defensive group, consumer staples—the safe dependables—is selling at attractive valuation levels rarely available.

If the market were to rise significantly or, for whatever reason, drop through our "floors", then we would want to react to mitigate the market downside. But probabilities are high that the market rises from here. However, when it rises to fair market value, or should we become concerned with market risk, we may wish to buy put options for authorized accounts to hedge market declines. This can be particularly effective when the cost of put options is low in an overly exuberant market, allowing the potential for gains even from a small market decline.

From a bottom-up perspective, it's not easy to find stocks to short today whereas, from the long side, we don't know what to buy first.

The Mighty Oaks

So, in addition to our smaller-cap favourites, in several of which we have concentrated positions, we are now also embracing large-cap undervalued stocks, which as a group are relatively cheap, and unusually, have lagged small and mid-cap stocks for a decade. The highest quality large-caps may now outperform. Moreover, these companies are stable, should be able to better withstand any economic downturns and market setbacks. And their liquidity should allow us to use our SVA™ work to trade them easily. One risk, however, is that the strong U.S. dollar will make U.S. exports less competitive and hurt the earnings of U.S. multinationals. So, some selectivity is warranted. A slowdown in Europe should slow U.S. trade growth somewhat too, though Europe represents only 13.5% of U.S. exports.

We are routinely asked about how we can be more defensive in the next major market downturn. Obviously in a significant decline, where most stocks are impacted, our long positions will likely decline too. Though, at the portfolio level, we do have the ability to raise cash, hedge our longs with a meaningful short exposure (for Long/Short accounts) and/or buy put options (where authorized) to insure against a market decline.

Our increasing larger cap positions should allow us to easily exit on sell signals in our work if overall market psychology appears to be pushing them lower, with a view to repurchase—at lower levels—i.e., at the next floor down in our work. Larger cap stocks also tend to fluctuate less than small caps in most declines so that could also help mitigate any temporary loss from volatility.

Though none of our core large-cap holdings is currently "on sell", if sell signals do occur we intend to react. GameStop recently went on sell which prompted us to exit (even though it trades at only 8x free cash flow) just as earlier in the year we reduced our *Aetna* position based on a sell signal though we just added to it as the stock bounced up off a "floor" after the recent market decline.

It's perverse that with investors so nervous again that some of the safest places to invest capital now offer such unusual potential reward. Large-cap U.S. stocks, particularly the safe dependables, many high quality, continually growing, predictable businesses, are now trading at prices well below their Fair Market Values (FMV).

Clorox, for example, compounded its FMV growth by about 10% per year over the last decade, growing even through the recent recession. At 14x next 12 months earnings it trades at an attractive price—nearly a 25% discount to its FMV.

The safety of Clorox is derived from its sheer size, its solid balance sheet, consistent high returns on capital and its earnings quality, an astute management team and the leading market share of its brands. And most important, the company's products are essentially recession-proof consumer staples—everyday use products which must be regularly replaced, such as Clorox bleach, Liquid-Plumr, ArmorAll, Pine-Sol, Glad, Brita, Kingsford and Burt's Bees.

What appears safe in the short run is not necessarily so in the longer run. T-bills, investment certificates and bonds may offer a predictable return *of* capital but, at today's low rates, may not return enough *on* one's capital to keep pace with inflation. Compared to a bond, there is higher risk of Clorox providing a return *of* capital in the short run. However, over time, Clorox offers a substantially higher potential return *on* capital. With a 3.5% dividend yield compared to the 10-year U.S. Treasury yield of 3.2%, on dividend alone the company returns you more than the *sure* instruments. Even Clorox's own 5-year bond yields less than its dividend—a dividend that has regularly increased for 33 years. Clearly, the shares are the preferred investment.

Clorox represents what we ideally want in a stock holding—below-market risk with above-market potential reward. In our work, it is worth over $80 today (the price is $63), ought to be worth over $90 in a year and more than $100 in two years—a two-year potential return of over 30% per year (including dividends). Clorox typically trades efficiently very close to its FMV. But, the current market is still wringing out the inefficiencies from the Panic which has left Clorox, and other safe dependables, as undervalued investments.

New Big-Cap Trees

We recently added *AFLAC*, another big-cap stock, and also increased our *Goldman Sachs* position as this preeminent leader in the investment banking field was dragged down to a floor in our work (a mere 7x earnings—65% of fair value) on the uncertainty of the SEC's investigation. It seems to us that Goldman did not act inappropriately but that even if the company decides to settle, the overall impact to it should be minimal.

AFLAC is a medical/health insurance company with operations in Japan and the U.S. It offers supplemental coverage to individuals above their employer or government insurance. The company's investment book has no material mortgage, commercial real estate or equity market exposure but does hold some positions in Greek, Irish, Italian, Portuguese and Spanish corporate and government debt and was severely punished for this exposure, though earnings impact would be minimal and its capital ratios would continue strong even from substantial direct loss from those investments, which we do not expect. The company trades at only 8x earnings or 60% of fair value. Both Goldman and AFLAC offer a 2-year return potential well in excess of 30% annualized.

In our mandated bigger-cap accounts we've also added *Oracle*, *IBM*, *Walgreen*, *Wal-Mart*, *Mastercard*, *Google* and some others—all high quality companies that have rarely traded at such discounts to their ever-growing FMVs. They offer unusually high potential rates of return for such high quality companies as the prices should revert back up to their respective fair values in the next year or two.

We continue to target at least a 25% annualized return for our large-cap holdings over the next two years versus our overall-market expected return of only half that in the comparable period.

Fast Growing Saplings

But our smaller cap holdings still offer the biggest return potential. And we believe are in businesses that can withstand or maybe even benefit from economic dislocations.

As, for example, gold, which recently made historic new highs from the flight from currencies, and as a potential beneficiary of either deflation or inflation.

Our significant gold holding, *St Andrew Goldfields*, continues to make progress. St Andrew reported record quarterly earnings in Q1 which should be higher this quarter based on similar production but higher gold prices. Exploration continues apace at 3 areas near the Holloway production site—Taylor, Smoke Deep (where some excellent results have already been announced) and Deep Thunder—where success could add meaningfully to current production and mine life. Ultimately, the Holt Mine currently in a royalty dispute could come on production too, and also with potential for resource growth. As one of the largest landholders in the Timmins Camp, with excellent infrastructure, outstanding management, an improving balance sheet from free cash generation, and the potential for meaningful resource and production growth, St Andrew remains a focus stock for us as we hold a concentrated position in client accounts (as well as very large positions held personally by members of the Abramson family and, as you know, Herb continues to be a director). Not to mention it just received its first two analyst reports—both Buy recommendations, one with a conservative target at its estimated Net Asset Value of $1.40, and the second a target of $1.60 using only a $1000 U.S. per ounce gold price. Indeed, the latter report of Sandfire Securities says, "the company provides the highest gold exposure in Canada per dollar invested, currently trading at 11.5 oz per U.S. $1000 of equity invested at the current share price." Our 3-year target is $1.80, a 20% annualized return over that period, without any rise in the gold price or exploration success.

Our focused overweighting in oil and gas should continue to pay off, especially with inflation, and particularly if the U.S. dollar starts to decline so that commodities, generally denominated in dollars, get cheaper for the rest of the world increasing global demand. We think natural gas prices have bottomed as production has declined and we should see significantly higher prices as the year progresses, especially into next year's heating season.

Corridor Resources, our largest holding in accounts by weighting, is trading below $5 but worth about $10, a value that should rise to $16 over the next 3 years (a potential return of 40% per year). The company is drilling a horizontal well in the McCully field, results of which should be made known shortly. Its farm-in partner, Apache, will soon drill the first two horizontal wells into the vast Frederick Brook shale, results of which should be known around year end and which could be game changing for the company. This summer, the company will drill 4 wells with a partner on Anticosti Island, where hopes are high for a significant oil find. By the fall, we expect the company to have landed a joint venture partner for its Old Harry prospect (a potential 2 billion barrels of recoverable oil) in the Laurentian Gulf. Positive outcomes from any of these could add substantially to the company's value.

Orca Exploration has climbed back up to $4.70, though the net asset value is still above $10 per share. Our current target is $8 and our 3-year target is $14, offering an annualized potential return above 40%. Orca recently gave guidance for the first time, stating that cash income in '10 should be between $15-20m. As the cash flow begins to be realized in each passing quarter, Orca is unlikely to remain at its current low valuation. The company also mentioned potential acquisitions and just announced a farm in on an oil permit offshore Italy which could be worth $1 to $3 per share. The company has also alluded to another acquisition and has made several positive management and Board changes. And in '11 the company plans to drill its Songo Songo West property, a look-a-like to its producing Songo Songo East property—low risk exploration drilling which could really drive value higher and lift the growth profile of the company over the next few months.

Opportunities Like These Don't Grow on Trees

These smaller-cap opportunities are especially opportune. The reward potential is high and we see little long-term downside risk for each of these holdings. Corridor and Orca are both debt free and St Andrew should, in due course, be too given the amount of free cash flow it is generating. These businesses are very well run, trade well below our conservative appraisals and there is low hanging fruit on each tree to add considerable value over the next few years.

Malaga—a Tungsten producer in Peru—is now cash flow positive earlier than its recently announced schedule and raised $5m to accelerate its growth plans. The shares trade for $0.13 (an $18m market value) but our appraised value is $0.50 ($80m). Our 3-year target is $0.90, a potential return of 7 times our current investment, or 90% per year. Malaga is the only Tungsten producer in the Western Hemisphere, no new mines are anticipated starting up anywhere until at least 2014 and demand for the commodity is increasing. Proceeds of the issue should allow drilling to be expedited so the company can continue to add reserves from its known 77 Tungsten veins. The company is essentially trading at 1x expected EBITDA as production is set to double in the next 12 months.

Petrolifera Petroleum just announced a significant gas discovery in Colombia and is awaiting results from a second Colombian well. Drilling in Argentina has also added value and we anticipate a partnership on its Peruvian properties in the near future which should allow the company to begin drilling there, hopefully in '11. This should all help move the share price back up toward our appraised net asset value, potentially 2 or 3 times its current price.

Serrano Energy announced it is being sold soon for $2.256 per share (lower than we expected) to a larger company. *Canadian Phoenix Resources*, Serrano's largest shareholder, also announced a sale for cash, of its other subsidiary—Marble Point, and will likely distribute the cash to its shareholders in the next few months.

Canoro Resources received a cash injection from Mass Financial whose interest is enhancing the existing oil and gas assets and also focusing on building an Indian infrastructure business. The company's net asset value is well in excess of its share price and the financing and growth plans should help drive the share price toward fair value. Assam, Canoro's joint venture partner in India, which covets the assets, is unhappy with the proposed Canoro financing but we anticipate a positive outcome for both parties.

We recently sold Ruby Tuesday after its rapid run-up toward $12 in light of our nervousness with the valuations of restaurant stocks generally. We would look to replace the stock should it fall back to the $9 floor, allowing, once again, some decent upside potential.

New Small-Cap Trees

Newly acquired *Xcite Energy* is a compelling situation. It is drilling for oil commencing this month on its UK North Sea property, its first production well. The well is high probability—over 90% chance of success. Our cost was $0.62, a serious discount from our appraised asset value of the company. A successful well will allow the company to book reserves, boosting its net asset value to a level multiples over the current share price of $1.02.

We also recently purchased a position in *Porto Energy*, a small private oil and gas company at $0.50 per share, to finance an accelerated seismic program and the start-up for its upcoming drilling program in Portugal. The company is expected to go public soon at a higher price than our cost, based on the value of the company's assets onshore Portugal—with several majors operating offshore—which is well in excess of our recent cost.

Both Xcite and Porto appear to be lower risk opportunities—debt free, operated by accomplished management teams, development drilling opportunities in safe jurisdictions—with potential high reward from vast resources relative to their low market caps.

Income Securities

After our Lanesborough Real Estate and Western Financial securities recently matured, we added high yielding *AT&T* common shares to our income portfolios and are acquiring high yielding Secured Debentures in another company shortly. AT&T yields 6.8% versus 10-year Treasuries at 3.2% and its own 10-year bonds at 4.3%. And, we believe the shares trade at a 25% discount to our $33 fair value estimate and growing—a compelling value. Though we rarely purchase common shares for our income portfolios, holding a position in a stable undervalued business with such an extraordinary high yield makes sense, especially when it's fallen to a floor in our work.

We have not marked up any of the securities that we marked down in '08/09, although most are worth more than our current carrying values and we expect them to mature at their full par values over the next couple of years.

A Time For Trees

As an asset class, equities are cheap and should be the most preferred. Different "experts" have extremely bifurcated opinions about the future of the economy, and therefore, the markets. But as the saying goes, there is a stock market and a market for stocks. The forest and the trees. Now is the time to focus on the latter. Good drilling news from Corridor would likely drive its price higher no matter the direction of the general market. Just as poor news from its Gulf oil spill would drive BP's share price lower no matter the overall market.

Market pundit, Leon Tuey, believes we are "witnessing a bona fide secular bull market and the best is yet to come." More important, he says, "Investors must not be mesmerized by the movement of the S&P or the DJIA….The emphasis should be on sectors and stocks." To *branch* out into the cheap, neglected trees, and ignore the obvious, well-discounted forest. You might say he and we are at *loggerheads* with the fearmongers and perma-Bears. We don't think we're going out on a *limb* when we proclaim that this is a time of unusual opportunity—a very good time to invest in very good cheap stocks.

Herbert Abramson and
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