THE PLAIN FACTS

2011 was a turbulent year marked by excessive investor pessimism. Japanese tsunamis, European economic tsunamis, Chinese tightening and a global slowdown caused stock investors to rush for the exits, seeking the perceived safety of cash and bonds. Markets around the world suffered.

10 of the 13 calendar years since the inception of Trapeze were up-years, '99 to '06, then followed by the down—Crash years of '07 and '08—and, then after a healthy recovery in '09 and '10, another down year in '11. Small comfort, but most value-oriented investment managers had a poor 2011 too, especially those with smaller cap, energy or basic material orientations. The smaller cap names we hold, undervalued as they were, declined unjustifiably to become even more undervalued and attractive.

Many big-cap stocks in 2011 suffered extraordinarily too. In the U.S., Dow stocks: Bank of America down 58%, Hewlett-Packard down 38%, Alcoa down 43%. S&P 500 blue chips: Sears Holdings down 56%, U.S. Steel down 55%, G.M. down 45%, Ford down 36%, Avon Products down 38%, Whirlpool down 45% and AMR went bankrupt. In Canada, Research In Motion, the biggest market cap on the TSX in 2007, down 75% last year, Cameco, a senior uranium producer down 53%, Teck, Canada's biggest mining company, down 41%, Manulife and Sun Life both down 34%, senior energy companies Encana down 33% and Talisman down 40%.

Indeed, the TSX was 9% lower and the S&P TSX Venture Exchange, a proxy for the Canadian small-cap universe, was down 35% in 2011. No excuses. We shouldn't have had that degree of drawdown and we intend to try harder to mitigate portfolio volatility, adding attractive large cap names with enhanced liquidity, trimming weightings more effectively on selling opportunities, and using options and short selling strategies (where clients authorize them) to try to diminish volatility, particularly in certain overbought periods. Yet, as value investors, we will continue to be drawn to small companies—big ones are less likely to have the same magnitude of pricing inefficiency.

Looking Ahead

The place to have hidden in 2011 was in U.S. treasury bonds, utilities and consumer staples. But that was then and this is now. Going forward we believe the emphasis should be on higher beta sectors of the kind we own—resources, basic materials, industrials and consumer discretionary.

Some of our favourite small-cap names that declined in 2011 did so excessively, from some negative news, as emotion trumped logic, but without, what we call, any "permanent impairment." And, in fact, for the most part, their businesses and future potential are the best they have been, and they are the cheapest they have been. And with potential catalysts in the next few months to move the shares higher. We don't speculate. We only want to buy cheap, out of favour, distressed assets with cash flow or the likelihood of cash flow in the near term—the attributes of our cheap small cap holdings. We believe that 2012 results from our holdings will justify our confidence in the potential of our holdings. Particularly as we believe 2012 should be a good year for stock markets generally.

Economies Growing

We believe that, while Europe will suffer a recession in 2012 on its painful path to recovery, with or without Greece, the U.S. and Canada will likely see accelerating growth this year, as will China, India and Latin America. In fact, global growth should be above 3%, supported by record high total household wealth in the world, which has doubled since 2000. China and India provide half of the world's economic growth. And manufacturing in India and China grew in December and should continue to do so from renewed government stimulation.

For North American stock and bond investors, the real story is the improving outlook for U.S. recovery, with GDP forecasts of about 3% for this year from higher business confidence levels and expansion plans. While Canadian housing growth may falter from diminished housing affordability (prices rising faster than incomes), U.S. housing appears to be bottoming with inventories continuing to fall (16% below year-ago levels) to almost normal levels, from pent-up demand (pending home sales in November were the highest in 19 months), record low mortgage rates, the most affordable housing ever, rents rising and housing starts at about a quarter of their previous highs and a growing population to consume supply. Confidence of U.S. homebuilders is at the highest in 4½ years.

Auto sales continue to improve too, with car makers enjoying the highest sales pace in December in over 2 years, and 2012 expected to be the best year since 2007.

Railroad freight volumes are surging recently, a good barometer of recovery. As sales growth improves, U.S. inventories will need to be rebuilt from tight levels, which should accelerate this year's industrial production and GDP growth. While retail sales have been only modestly better, consumers are increasingly upbeat—U.S. consumer confidence hit an eight-month high in December on improving job prospects. Jobless claims just hit a 4-year low, the unemployment rate dropping to a near 3-year low of 8.5%. For all of 2011, the economy added 1.6 million jobs, the most in 5 years. More jobs will ultimately translate into more housing and auto demand. And then, in turn, more jobs. The virtuous circle we last wrote about. Forget recession.

Nowhere To Go But Stocks

Most important for us as portfolio managers, though companies with a high proportion of foreign sales are being negatively impacted, U.S. corporate earnings have likely enjoyed another record in Q4, those earnings reports now upon us. And 2012 likely to be yet another record high earnings year. Corporations also have the best balance sheets in decades, with record cash balances. Yet the U.S. stock market, though recently improving, is still cheap, profits are strong and P/E ratios low—especially with earnings yields and dividends of stocks at the highest ever compared to the historically low U.S. treasury bond yields. In mid-December the S&P 500 dividend yield of 2.2% exceeded the 10-year Treasury yield of 1.81% by a record margin. And dividends will increase, along with share buy-backs—both already at record highs.

With a crisis premium baked into the market, stocks as an asset class should be by far the preferred investment. Government bonds, with yields lower than the inflation rate and potentially more inflation on the horizon, are subject to rising yields and potential capital losses if liquidated prior to maturity, along with a loss of purchasing power of the proceeds returned at maturity. Unlike the early 1980s when treasury bonds at 15% were low risk and much more desirable than equities. Today bonds are not low risk, with a negative real return for the 10-year (2% yield less a 3% inflation rate), while the growing earnings yield, the "return" on stocks, of about 8% at current P/E ratios, is twice the historical average equity premium over bonds. Investors in U.S. treasuries will suffer if inflation rises further. The 40-year bull market in fixed income appears to be over.

Forward earnings should continue to rise and multiples should expand. So stocks should do well in 2012, not only from their obvious attractiveness, but because they are underowned. Some of the largest investors are underinvested in equities. $1 trillion in money market funds and $7 trillion in bank deposits and cash. U.S. investors now have just over 50% of their assets in stocks, which is lower than at all times except the worst of the severe bear markets in 2002 and 2008. Moreover, the supply of available shares is shrinking as buy-backs exceed new issuances. Investors have withdrawn money from stock funds for 8 straight months, the longest stretch for at least 2 decades. When sentiment is so poor, stocks are so cheap, cash on the sidelines is so significant, interest rates are so low, corporate profits are at all-time highs, corporate cash too, and economic indicators are strengthening, the obvious conclusion is that stock markets should go higher. We have just suffered the second-worst 10-year period for U.S. stocks since 1920. After those severe downturns U.S. stocks enjoyed positive results in the following 5-10 year periods.

We Should Now Outperform

Big-caps have in the recent past been preferred for their obvious liquidity. We too are increasing our holdings there. In addition to several U.S. big caps, including Dell and Apple (top holdings described below), our "larger-cap" accounts' key holdings also include *Berkshire Hathaway*, *Best Buy* and *Oracle*. But small-caps will inevitably, eventually, catch up and, we believe, outperform, being much cheaper than their big-cap brethren, and not needing excessive demand to drive them higher as increasingly confident investors move down the liquidity chain.

We believe the worst may be over, and accordingly we look forward to 2012 as a year of positive performance for us, especially from the favourable developments we anticipate from our holdings in the near term. Our stock holdings are at unwarranted lows. And we believe, based on valuations, compelling stock yields compared to meagre bond yields, the prospects for world economic recovery and negative investor psychology priced into the market, that we are likely into a multiyear upward trend in equities.

The best money managers can flounder in any year and many money management stars were humbled in 2011. Bill Miller, the Legg Mason manager, famous for beating the S&P 500 for a record 15 years through 2005, stepped down after trailing the index for four of the past five years. John Paulson’s Advantage Fund which had positive performance in '08 was down 52% last year. Top U.S. stock pickers, Ken Heebner of CGM and Bruce Berkowitz of Fairholme Capital Management, both suffered last year. Volatility took no prisoners.

Interestingly, Don Hays of Hays Advisory who also underperformed in 2011 says, “Any year that I have underperformed was followed by an outstanding year of outperformance.” Ditto for us. Previous years, such as 1998, when we significantly underperformed, were followed by lengthy periods when we significantly outperformed, namely 1999-2006. From the severe undervaluations of the stocks in our portfolio, in an improving environment more favourable to equities than 2011, we believe the probabilities are good for us to achieve a period of outperformance. If we continue to hold and buy good, very undervalued businesses, the recent underperformance from irrational investor pessimism should ultimately lead to outperformance.

The smart money thinks so too. Warren Buffett’s Berkshire Hathaway made more investments in the third quarter than in any period of the last 15 years—$23.9 billion, expanding into more commercial and industrial stocks from the safe dependables.

Our Top Holdings

The following is an analysis of our largest holdings including our target prices which are in most cases multiples of their current share prices.

Manitok Energy is an oil and gas exploration and production company operating in the Foothills of Central Alberta. The company was established in 2010 when land prices in the area had declined to 1998 levels as majors with land holdings in the Foothills, who had previously conducted extensive deeper natural gas drilling campaigns, concentrated elsewhere and technical challenges discouraged new entrants. From inception through 2011, the company has been successful in posting highly prospective land adjacent to its existing land holdings and near established oil and gas infrastructure.

Manitok’s competitive advantage in the region stems from its experienced management team that has drilled hundreds of wells in the area. The chance of success from Manitok’s drilling is high (and therefore drilling risk low) due to the development (i.e. not exploration) nature of the drilling in areas with ample seismic and borehole data. Further, the commensurate rates of return on capital spending are high too given the characteristics associated with the company’s specific prospects: they have high expected internal rates of return from their conventional

drilling (approximately 100% anticipated IRRs from both their Cardium light oil wells and their liquids-rich Mannville gas wells). Importantly, Manitok's drill program is not dependent on improving commodity prices.

Financial risks are minimal as the company has no debt and substantial cash flow. Today, Manitok is producing 2,300 boe/d and the company could ramp up production to 5,000 boe/d over the next 12 to 18 months, given their current drilling inventory.

Risked net asset value has grown to about 50% above the current share price. Low risk development drilling, a well-capitalized balance sheet (with access to a $30 million reserve based operating line) to fund their well articulated plans, a competitive advantage in their region, high expected internal rates of return from conventional drilling and a proven management team all combine for an investment with low risk of permanent impairment and above average potential reward.

Manitok has been off the radar screen, only coming public in October of 2010. The current price provides a drastic discrepancy between downside risk (where the stock could fall to in a downside scenario) and reward (where the stock should trade over time). Manitok did fall from recent highs after a bought deal equity financing that satisfied current demand. However, the company is now drilling one well a month and the market should take notice. We expect results from the first of many wells imminently. Production could double by the end of this year, in turn doubling the net asset value and potentially more than doubling the share price.

Dell's share price has held steady for a number of months as it continues to morph away from its PC business (a negligible portion of profits). We continue to be attracted to Dell because of its rising FMV, now in the mid to high $20s. The company has over $8 billion of net cash and generating more from record free cash flow (over $4 billion annually). Excluding the cash from the overall enterprise value, the company is trading at less than 5x free cash flow, remarkable, for one of the top global brands. At the current pace of growth, the company will have as much cash as market value in just over 4 years and we'll be getting the entire business free. There's a likely floor in place too as the company is buying back billions of dollars of shares.

Operationally, the company remains a low cost producer with competitive advantages in its core product lineup—servers. And its working capital balances still provide a positive carry as the favourable payables terms continue to finance the receivables.

CEO, Michael Dell, has a clear strategy for growth. Windows 8 (arriving by the middle of this year), which Michael Dell referred to as revolutionary, should alone provide growth from the expected upgrades, both at the enterprise and PC levels.

Even in a no-growth scenario, which we don't foresee, but which allows us to stress-test Dell's valuation, the company's actual trailing 12-month free cash flow supports a value in excess of the current share price. The company's growth strategy is paying off. A mere jump back to 10x free cash flow, plus its cash and the reasonable growth we expect has the potential to lift the shares by over 40% per year over the next couple of years. The company has already been

detached from fair value for over 18 months—an unusually long period of time for a large-cap company. A rebound back up toward fair value in the next 12 months seems likely while the company continues to produce record free cash flow.

St Andrew Goldfields' price ran up significantly in 2010, then fell considerably in 2011 in reaction to some temporary issues which led to much slower than anticipated production in the first part of the year. The third quarter however, showed record production and lower costs. The fourth quarter was another record for production and other metrics should be even better than Q3. Yet, St Andrew trades well below its net asset value. We see future gains in the net asset value as the company continues to add to its resources and reserves—St Andrew is in the early days of exploring its 120 kilometer stretch of the Timmins, Ontario mine camp, the largest land package in the third most prolific mine camp in the world.

Most gold stocks, but particularly the juniors, have suffered since the bullion price highs of last summer. We see little downside for the company, other than moves in sympathy with any downside volatility in the price of gold. St Andrew's state-of-the-art infrastructure, mines and experienced management team all provide it with low technical risks. The company is growing, generating significant cash flow (with extensive tax pools to shelter profits) and the balance sheet is clean with over $15 million of cash, so there are low financial risks. The company should produce a record 100,000 ounces in 2012, growing further over the next several years. Its gold note financing program will be fully retired by the end of 2012, allowing even better cash flow and earnings thereafter.

At the same time, the attractive valuation provides a substantial margin of safety. St Andrew trades at a material discount to its net asset value (a 50% discount even using a $1200 gold price). Even assuming no material addition from exploration, we have an upside target of $1.60 in 3 years (assuming a lower gold price of $1400 and 8x cash flow), over 3 times the current share price. At the current price of gold, based on the growing production we anticipate, St Andrew could have as much cash as today's share price in about 3 years, so we'd be getting the entire mining operations and other assets free. Needless to say, at current gold prices, or if inflation escalates and gold prices move even higher, St Andrew could have even more potential upside.

Specialty Foods manufactures packaged meats. Its main product line is Nathan's Famous hot dogs, the leading hot dog brand in the U.S. We have owned the company's convertible debentures for 5 years. The value of the company greatly exceeds the total outstanding convertible debt. The company should earn about $10-15 million per year of free cash flow. Between its free cash flow and some asset sales, the company has paid down all of its bank debt and half of the original outstanding convertible debentures (originally $58 million) at par. The company is now buying back all of its Canadian debentures (over $5 million) and a portion of its U.S. debentures (over $2 million) at 115 (a 15% premium to par). For most clients holding the U.S. debentures, rather than tender for cash, we are electing to receive a new 8% non-convertible debenture and warrants which can be exercised into equity.

We would like to see the company extend its contract with Nathan's, but even if the existing contract is not renewed and expires in March of 2014, the debentures/warrants value should have a total value that is over 30% higher than our current carrying value. If Nathan's and the company can agree to a long-term renewal, the value of the debentures/warrants will be well in excess of our carrying value.

The pro forma debt will only represent about 1x expected EBITDA and interest coverage should be about 10x—extremely attractive leverage ratios. Most importantly, the free cash flow provides the capability to pay down the debt in just over 2 years and the debenture is scheduled to be repaid in 3 equal annual increments beginning in June of this year.

We will recoup two-thirds of the debenture within 18 months (one-third by June) but retain the warrants. Without the Nathan's renewal there's a present value of about 150 (our carrying value is 115 today). With a Nathan's renewal the value balloons to likely over 200. With the new debentures on redemption returning our cost, we would be left with the warrants free, to earn the upside from a positive outcome for Specialty's equity value.

Orca Exploration detached markedly from fair market value beginning in the middle of last year when it announced the need to do remedial work on the liner of some wells which temporarily slowed production and utilized cash. The share price recovered somewhat only to fall again after the company reported it had been dealing with a negative report issued by a low level parliamentary committee in Tanzania. The company is discounting the report and indicating it is unconcerned. Notwithstanding, these announcements have left Orca's share price at about one-third of our appraised value.

Ironically, the company's prospects have never been better. The government has signed an agreement with a Chinese sponsored group to build a major pipeline. It took multi-Tcf discoveries in the region by 3 major independent oil companies—supporting the government's long-term plans for gas-fired power generation—and a worsening power shortage from drought conditions limiting hydro power, to expedite the country's infrastructure plans. Orca has now increased its own capacity to supply gas and is now prepared to drill additional development wells and complete remedial work to further increase its total deliverability to 4 times its current production level. Production and cash flows are now at record levels. And the pipeline, expected to be completed later this year, will allow a ramp-up of production to a much higher level. The reserves of Songo Songo East alone produce a valuation of at least double the current share price. The company will be drilling in Italy shortly too and will drill a high potential exploratory well at Songo Songo West in Tanzania by mid 2012 which could add materially to the net asset value.

Orca is a utility-like business. It provides natural gas for power, mostly at regulated prices, to the Tanzanian power utility, and also to local industrial users at negotiated prices. Tanzania and the adjacent regions are gas-starved and require gas to power electricity merely to avoid the regular brownouts. Orca has long-life reserves and operates at low costs with high netbacks. The company has a clean balance sheet with working capital in excess of $50 million to grow its business.

Orca will likely be sold (like its predecessor Pan-Ocean Energy) in the next couple of years (the company will be very desirable once the pipeline is compete) for at least 3x the current share price, but perhaps 5x or more depending on drilling success in Songo Songo West—Orca represents the only major gas development offshore East Africa. Now that other discoveries have been made by majors, those majors will likely covet Orca's infrastructure, contracts and significant head start in the region.

With Tanzania and surrounding regions power starved, production should continue to increase and with some success from exploration in Italy and Songo Songo West, a mid-teens target in 3 years is not unreasonable, providing a potential 5-fold return.

Corridor Resources' share price has clearly been disappointing. It declined for a number of reasons last year. Apache, its previous joint venture partner for its shale gas project, elected not to proceed with a second stage following poor results from two horizontal exploratory wells, which is believed were not drilled effectively.

Then, after a proposals submission process, Corridor announced that it was not yet able to attract another partner for its Frederick Brook shale gas project, primarily attributable to the unusually low gas price environment. The company had over-optimistically believed the project was so robust that potential partners, major oil and gas producers, would look through the current poor gas prices to their future recovery. With oil now at a record 40 times the depressed price of natural gas, understandably there are very few companies allocating capital to new gas projects.

Corridor still intends to look for a partner to proceed with a pilot project to establish commerciality at the Frederick Brook. The size of the prize remains enormous—over 59 Tcf gas in place according to third party engineers—that should ultimately attract interest. Corridor's first targeted shale well, its G-41 well, which Corridor itself drilled vertically, had excellent results. If the initial flow rates from subsequent Frederick Brook wells are less than half of G-41, with a gas price of around $5, the project's economics appear adequate. The wells Apache drilled encountered strong gas shows and pressures while drilling. And the company's recent appraisal well showed extremely promising results with gas shows in 8 separate zones over nearly 1000 metres of depth.

Of course, as with any holding, we continue to reanalyze the company to try to ensure we are not missing anything. And we remain optimistic for a number of reasons. Natural gas prices should bottom soon—while the storage tanks are still filled, the number of operating gas rigs keeps shrinking (down 14% since last year); the storage build has been reasonable recently even though weather has been unseasonably warm; the price is well below the North American marginal cost of production; demand keeps growing as the US economy recovers; the incentive to continue to switch from oil and coal to gas remains high with the record oil to gas ratio; and LNG facilities are in the works to export gas to foreign markets where gas prices are dramatically higher, further removing supplies.

But bottom line, the company's proven and probable reserves, infrastructure and land value alone remain about $2.50 per share—2.5x the current share price. And we're getting the massive Frederick Brook shale gas project, and the other significant potential of Corridor, free—namely the Anticosti Island, Quebec shale oil project (19.8 billion barrels of oil equivalent resources in place) where it is hoping to attract a partner by the end of March and Old Harry in the Gulf of St. Lawrence (potentially 2 billion barrels of oil recoverable) where it is also seeking a partner to drill in late 2013 or 2014. Petrolia, Corridor's joint venture partner in part of its Anticosti holdings, whose assets mainly consist of Anticosti assets, about 40% of the joint venture, itself has a market cap that's almost Corridor's, $90 million, implying Corridor's price is far too low given the immense potential of its overall asset base.

Looked at another way, Corridor is now trading at a price merely equivalent to its infrastructure—the replacement value of its gas plant and pipeline of about $100 million.

Furthermore, Anticosti's land value alone is likely worth well in excess of $100 million. In early December, Corridor announced further analysis of its Anticosti Macasty oil shales. It alluded to "highly prospective oil and gas production potential" showing hydrocarbon saturation reaching 70% which is positive for shale productivity and "exceptional shale permeabilities", further commenting that the shales are similar to that of the Utica shale in Ohio where land values have ballooned and a number of major E&P companies are active.

Meanwhile, Corridor remains debt free with $6 million of working capital, generates cash (about $7 million expected for 2012) even at these low gas prices, and owns several projects that have enormous potential.

The Children's Investment Fund (a value-oriented UK based fund) bought a sizable position in Corridor about a year ago and remains the largest shareholder, with one of its portfolio managers on the board of Corridor, and recently added to its position—it owns just shy of 20%.

We remain invested in the company because our conservative appraised value is still well above the current price. Again, while Corridor trades for about $1, its current core net asset value is $2.50 and its risk-adjusted NAV is still above $10. Gas prices cannot stay this low indefinitely. We have not altered our appraisal of the company, though the timeline to surface value from its Frederick Brook shale prospect has obviously been extended.

***Xcite Energ*y** ran up from its early 2010 lows following drilling success at its Bentley field in the UK North Sea. It then fell precipitously in May of 2011 after the publication of a poorly communicated reserve report which was misunderstood or misinterpreted by the market. Essentially, third party engineers assigned the company 28 million barrels of reserves, leaving another 87 million barrels as contingent resources. The market was likely anticipating that the full 115 million barrels would be booked as reserves. However, management has stated that conversion of the contingent resources to reserves is anticipated from project sanction and deliverability of the field development plan, not from any required additional technical work. Assuming, as we anticipate, Xcite receives approval for a staged development process shortly then all 115 million barrels should be included in the reserve category.

Perhaps more importantly, the booking of reserves will indicate that Xcite has now proven the commerciality of the Bentley field. The company completed a successful commercial flow test in December 2010, 3,000 barrels per day from a low-risk development well, greater than expectations. The reservoir quality was also better than expected, which should lead to enhanced economics with relatively low operating costs of $55 per barrel once production begins.

Shares of Xcite have been held back by the uncertainty surrounding potential debt and/or equity issues to finance its field development program. However, the company recently announced a private placement and equity credit facility that can fund the development of the project. Final government approval of its project is expected shortly, which should facilitate a debt financing thereafter.

The company has a clean balance sheet with about $100 million (or nearly $.50/share) in net cash on hand. At current price levels, the stock trades for around $1.80 per barrel if we assume the contingent barrels are converted to reserves, whereas it should trade closer to $10 per barrel. For comparative purposes, a nearby operation, with 200 million of proven and probable barrels of reserves, was acquired in 2010 for $3.1 billion, or $15.40/bbl.

Xcite's independent reserve auditor, in the May 2011 reserve report, indicated that the present value of just the proven reserves amounts to $1.10 per share. The auditor also ascribed an after-tax net present value of $0.80 per share for probable reserves. The contingent resource assigned amounted to another $4.65 per share best case (the likely additional proven and probable reserves). That amounts to $6.55 per share (compared to a $1.50 share price) of total proven and probable reserves, again assuming that contingent resource is mechanically converted to reserves once Xcite receives government approval to proceed with the full field development plan. The barrels are in the ground and management is focused on establishing the equity and debt financings necessary to fund the development program.

With an asset value at least 4x today's share price, even allowing for further share dilution, there is high upside potential. And even more upside from additional reserve delineation, higher oil prices and the potential for enhanced oil recovery. The company will likely be acquired within the next couple of years once additional reserves are booked and oil is flowing.

Pivot Acquisition, in which we own convertible debentures, is a fast growing private company operating in the IT outsourcing business. Pivot is a hardware-agnostic IT project and program management and software developer.

It is led by a world-class management team. The company was cofounded by four manager-partners including John Sculley (Chairman, former CEO of Pepsi and Apple) and John Paget (CEO, former CEO of two major IT resellers). Corporate IT outsourcing is currently being driven by conservative hiring practices and catch-up from a long period of underspending on IT capital projects. Pent-up projects entail complex virtualization, cloud computing, security and data needs which require multiple partners and one central project engineer.

Pivot acquires other similar companies, typically at less than 4x EBITDA, where it has potential to reduce working capital (improve accounts receivable) and enhance margins via selling synergies, corporate cost leverage from shared services and generating a higher margin from a sales focus which emphasizes services.

Pivot has an advantage over most competitors who often offer only one hardware banner, it has mostly variable costs allowing it to scale back if necessary, and acquisitions are done at low prices and conservatively with half the purchase price satisfied through earn-outs.

The business is well capitalized, with debt and interest well covered. Expected revenue for 2011 is $1.2 billion with an EBITDA run rate of $50 million. The company intends to go public, raising additional capital, and there are penalties which result in bonuses to the debenture holders if an IPO is not accomplished within a set timeline.

Assuming a 5x EV/EBITDA multiple for IPO valuation purposes (the public peers typically trade at 5-7x), Pivot's total enterprise value is $275 million (based on the 2012 EBITDA expectation of $55 million excluding acquisitions), whereas today's implied value is about 3x EV or half of where its peers trade. Our conversion price is 50% of an IPO equity valuation. That provides a potential 2.4x lift over our existing carrying value of par for the bonds and we earn 12% on this convertible bond while we wait.

Southern Pacific Resources (STP) is focused on the development of its in-situ oil sands project in the Athabasca region of Alberta. Existing production of 4,500 barrels per day from STP's Senlac project in Saskatchewan currently serves a dual purpose, allowing the company to develop expertise in operating a thermal-recovery project, but also generating solid cash flow which should continue for up to 15 years.

STP's seasoned management is now focused on its core asset at McKay. The first phase of development of STP's 100% owned McKay Project is fully permitted, fully funded and construction is well underway. Work is on schedule and slightly under-budget with over 80% of the total forecasted cost of $440 million incurred to date. Drilling and completion of the initial 12 SAGD well pairs has finished—all well pairs encountering high quality reservoir throughout, with an absence of lean zones and shale barriers in any of the well bores.

Notably, the location of the McKay Project, approximately 45 km northwest of Fort McMurray, gives us confidence in the quality of the reservoir. The company's lands are adjacent to the Suncor McKay River SAGD project, which began producing oil in 2002 and today produces approximately 30,000 barrels per day of bitumen. In response to the success of the project, Suncor has plans in the works to expand capacity with a second project phase. STP's acreage also happens to be contiguous with Athabasca Oil Sands' McKay River project. PetroChina recently agreed to buy out AOS' remaining 40% stake in the project for $680 million, which is scheduled to begin producing 35,000 barrels a day by 2014.

Excluding the debt tied to the McKay Project, Senlac's SAGD production alone nearly justifies STP's current share price. When we add the value of its McKay project, where 10,000 barrels per day come onstream in fall of 2012, our total net asset value is over 3x the current share price. We are comfortable with the company's debt level which should get paid down quickly at reasonable oil price assumptions. The cash flow from the existing production alone could pay off the debt in an acceptable time frame.

STP recently released a reserve and resource update where the company's third party engineers ascribed $1.7 billion of proven and probable reserves. Because the company has filed an application to expand the project to a total capacity of 36,000 barrels per day over what management believes to be a 20 to 25 year optimal project life, the update included this incremental value. In the near-term McKay will almost quadruple STP's production by late-2012 to early-2013. A valuation of eight times 2013 cash flow, based on an $85 per barrel oil price, provides almost three times today's share price. Using a discounted cash flow analysis, STP could potentially be valued at $7 per share range ($1.56 today) over the next 3 years, implying significant upside.

Apple was a recent portfolio addition. While a popular "growth" stock, it currently represents an investment opportunity not typically available to a value investor. In the last few years, on virtually all fronts—supply chain, management, retail, technology, and marketing—Apple has been unquestionably the most innovative company in the world. This innovation has propelled Apple far ahead of its competitors. Today it is the largest company in the world, offering the most sought after consumer products on the planet, all while earning the highest margins in its industry. Such a company typically commands a premium valuation. Unusually, this is not the case with its share price today.

Apple trades at a valuation well below that of the median market stock. If we just take Apple's 2012 estimated after-tax free cash flow, assuming no growth, and discounting it by 10%, the stream of cash flow is worth over $400/share. Adding the cash on the balance sheet (almost $90 billion) results in a value in excess of today's share price. In other words, assuming present operating margins hold, Apple trades as if it will never grow operating earnings again.

The upside potential becomes clear when we factor in growth. If we assume merely anticipated GDP global growth of 2-3%, Apple's appropriate valuation is about $600/share.

The stock appears to have very little downside with plenty of upside at current margins. Even if we stress the margins and drop the average selling prices (ASPs) of products and unit growth rate from current levels, we reach the same conclusion. To be sure, it is tricky to forecast in this fast changing industry. However, our analysis is on the conservative side and assumes: iPod will keep falling by 10% per year and fall by 15% beginning in 2017 and more thereafter; iPad growth will decline to 10% from 20%, falling to 5% thereafter; iPhone growth will fall to 20% from 25%, then decline to 10% by 2017; Desktop and Portable will bump along with 5% unit growth.

We use the last year as the high watermark for iPhone and iPad pricing. This analysis does not take into consideration new product launches. For example, it is rumoured that Apple will launch a low-cost iPhone for emerging markets. This will of course reduce the ASP but the unit volume would rise. We also assume the gross margin falls to 35% from 40% currently.

Many of the risks that have until now kept us on the sidelines have already played out. Steve Jobs has regrettably passed. The company has navigated its way through the biggest product launches in history. The costly retail store initiative has far exceeded expectations. Apple now sits at an exciting point in its history; new versions of all of its products will be introduced in the next 12-18 months. Expansion to international markets is firing on all cylinders. New disruptive products are about to be launched. Our valuation target in 2 years justifies a potential lift of over 25% per year.

Income Accounts

We believe our income holdings are stable. In fact, in the last 29 months, since the poor period of '08/'09, we've only experienced 5 small down months—the worst, down 1.3%. Our track record for our income composite since inception (October 1, 1998) is 8.6%, annualized, after fees.

Our income accounts are invested with the intention of enjoying a stable return and receiving regular periodic income. Holdings may include government and corporate bonds and debentures, preferred shares, REIT and income trust units and high dividend-paying common shares. Currently our income holdings are mostly higher yielding securities of corporate issuers where we believe the risk/return is favourable and often with potential for capital appreciation. Though less liquid than investment grade or government-issued bonds that provide much lower yields.

Because we are concerned about rising inflation levels globally and therefore the potential for increases in interest rates, we prefer relatively short-term (2-5 year) bonds where one is less susceptible to capital loss from rising rates. We currently have little interest in government bonds which, depending on the term, yield only a paltry 1-3%, nor in investment grade bonds which currently yield less than 4%.

In contrast, our holdings today have an average current yield (income we receive as a percent of current prices) of around 9%. Our expected yield-to-maturity is even higher from anticipated capital gains as discounted positions increase to their maturity value, and from the conversion privilege (based on the equity value) of some of our convertible securities as their underlying stock prices increase, and from a revaluation up in the undervalued common shares (Student Transportation, Brookfield Real Estate) we hold.

The best value for our income accounts today is in high-yield corporate bonds and we review many issuers in an attempt to find opportunities where interest coverage and asset coverage are well above average with risk of permanent loss appearing minimal, and returns relatively high (both from current income and potential capital gains). Though not always easy to do so, we are finding these opportunities in a diverse group of businesses across North America.

Based on our analysis, the income securities we hold are attractive with downside risk protection.

Specialty Foods' new debentures will continue to be well covered by assets and earnings—the company can pay its obligations with 2 years of free cash flow—and will have a sinking fund to pay down the debt in 3 equal annual increments beginning in June plus we will continue to hold an option in the equity, now in the form of free warrants to potentially benefit from its substantial equity value; *Advantex* debentures are fully secured by the company's receivables; *Pivot Acquisition* convertible debentures—a fast growing company led by a world-class management team with substantial asset and interest coverage; *Student Transportation* operates an extraordinarily steady school busing business; *Southern Pacific Resources* convertible debentures where the company's low-risk, long-lived oil sands assets generously cover the overall debt; *Smith & Wesson* bonds with extremely high asset and earnings coverage from a leading and well-established franchise—the company has as much cash as debt; *Dynacor* debentures, the only debt of the company, are secured and asset and earnings coverage is substantial (and we receive a bonus amount too if the company exceeds an EBITDA threshold); *Lender Processing Services* is far and away the market share leader in its mortgage servicing field and the company should have more than enough free cash flow to mature its bond obligations; *Ticketmaster* bonds which have solid earnings coverage and the company maintains an oligopolistic position; *Uniserve* where the asset value is in excess of the preferred shares that we hold and the company has no debt.

We recently acquired *Malaga* debentures which are secured and the asset and earnings coverage are substantial (and we receive a bonus amount too if the company exceeds an EBITDA threshold).

For these companies, with the sole exception of Uniserve, interest obligations are well covered by profits, with asset values well in excess of their debt obligations.

Each position is undervalued. Otherwise we would not own it. Moreover, in the case of Advantex, Pivot, Southern Pacific and Specialty Foods, has warrants or is convertible and the upside potential is significant. For the high yielding common shares we own, all have potential upside too as they trade below our appraised values.

Value Investing Does Work

Needless to say, while our dedicated income accounts did well and our "larger-cap" mandated portfolios declined much less than our legacy small-cap oriented accounts, this has been an anxious period for us and our clients who still hold an overweighting in small-caps. But value investing, over a longer period, does work and we cannot emphasize enough how attractively cheap and prospective our portfolios are now, with a significant margin of safety from stocks trading far below their intrinsic values.

Value investors are invariably contrarian. The value propositions are obviously most frequently in the least popular groups and names. We don't buy indexes—they are likely not the best valuations. We seek to capitalize on market inefficiencies. To pay more attention to price and long-term value rather than short-term volatility. This is a time of unprecedented opportunity and investors should be emboldened to add capital when their portfolios are so cheap. It is all logical. And logic, and value, will out. That's the plain fact.

Herbert Abramson and
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