Precious Metals Sector Review

Many of our recent newsletters have focused on our energy sector investments. This edition of the Armstrong Schmidt Perspective will focus instead on our precious metals investments, mainly because we are disappointed with their first half performance but remain excited by their longer-term potential. Currently, approximately 20% of the Total Return Portfolio is invested in the precious metals sector.

The table below quantifies the performance of our precious metals investments so far this calendar year:

Company	***Dec. 31, 2010 Price***	***June 30, 2011 Price (End of Q2)***	***% Return (First Half of 2011)****	***Recent Price (July 13)***	***Updated Year To Date % Return****
Goldcorp Inc.	$45.88	$46.65	+1.7%	$52.12	+12.0%
Pan American Silver Corp.	$40.93	29.87	-27.0%	$31.75	-22.4%
Silver Wheaton Corp.	$38.98	$31.83	-18.3%	$36.79	-5.6%
Yamana Gold Inc.	$12.77	$11.26	-11.8%	$12.63	-1.1%

* *Return calculations do not include dividends paid during the period.*

As shown in the far right columns, their performance has improved since June 30, which is encouraging. Our position in Agnico-Eagle Mines Ltd. is not shown above because we purchased it in April, 2011 (at $63.30). It closed at $60.98 on June 30 and $62.95 on July 13, meaning we were down 3.7% on that investment at the end of Q2 and 0.6% year to date as of July 13.

At the end of Q2, the only bright spot in this sector was the positive performance of Goldcorp, our largest precious metals holding and our second largest overall portfolio holding. Looking at the sector generally, the iShares CDN Gold Sector Index Fund, which tracks the S&P/TSX Global Gold Index, lost 13.2% during the six month period ended June 30, not counting dividends.

There will inevitably be periods of underperformance for every sector from time to time. The important question is whether anything fundamental has changed to make the particular companies we hold less attractive. We have a number of thoughts on that:

-The price of gold actually rose during the six month period (+5.5% in US$ terms and +2.3% in Cdn$ terms), and since then, it has approached all-time highs.

-The price of silver has also risen during the period (+11.8% in US$ terms and 8.5% in Cdn$).

-All of the companies we own in the sector have decent (excellent in some cases) growth potential, and all are trading at low or reasonable valuations. For example, we think Goldcorp's 2015 production could be up to 60% higher than its production levels were in 2010.

-There are legitimate concerns about mining costs (such as fuel and labour) rising around the world; however, the companies we own tend to be lower-cost producers relative to their peers, offsetting some of these concerns.

-Pan American Silver did encounter one specific issue that impacted its stock price negatively, namely media reports in April suggesting the Bolivian government may take control of some privately operated mines. So far, this has not happened to the company's San Vicente mine, which represents only approximately 6% of the value of the company. Apparently the local union has voiced its formal opposition to the government taking control, which seems positive.[1]

-Though we have chosen to ignore it in our decision-making process, there appears to be a seasonality to the prices of precious metals and precious metals mining stocks, with stronger prices tending to materialize in the second half of the calendar year.

-We think that the key question for longer-term investors when evaluating these companies is whether or not the secular trend towards higher gold and silver prices has come to an end. We believe it is still intact. Mistrust and mismanagement of currencies and instability in the global financial system persists. Interest rates remain at emergency lows in many countries, reducing the opportunity cost of owning metals. Worldwide demand for gold and silver is still growing. For example, India's state-owned trading company

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[1] Raymond James Ltd., *Pan American Silver – Company Brief*, April 20, 2011.

MMTC announced on July 7 that it would import 350 tons of gold during its fiscal year to meet rising local demand, an increase of more than 40% over the previous year.[2]

-On the supply side, companies are having problems finding new high-grade deposits (and the companies we own already possess some of the best ones). There was a great July 7 Financial Post article on this topic.[3] In it, an analyst notes that the number of deposits and total ounces found peaked in the 1980s and have been steadily declining ever since. Additionally, the cost of discovery increased from US$10 per ounce in the 1980s to more than US$47 an ounce in 2009, and there has been a decline in the average gold mining grade from 10 grams per tonne (in 1965-1975) to less than one gram in 2008. These industry difficulties could contribute to higher gold prices and support strong valuations for companies with growing production.

Taking all of these factors into account, there have been no fundamental changes that would cause us to alter our positive long-term view on the precious metals stocks that we own. Therefore we intend to continue holding the companies mentioned above.

That said, we are fully accountable for our decisions and our performance, as these investments have contributed substantially to our first half of 2011 returns being disappointing (-5.1% for our Total Return Portfolio, after all fees, compared to -1.1% for the TSX Composite Index).

In hindsight, there have been some tactical trading opportunities with these precious metals investments that we have missed. We are not suggesting we should have made major changes to react to short-term fluctuations, but trimming positions somewhat into the strong markets of Q1 and repurchasing a few of those shares later would clearly have helped returns. Volatility creates opportunities, and next time around, we may be somewhat more active to take advantage of the swings. That said, the nature of long-term investment necessitates patience during periods when good companies temporarily underperform, so there is no perfect solution.

The European Debt Crisis

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[2] Commodity Online, *India to import 350 tons of gold, 1200 tons of silver*, http://www.commodityonline.com/news/India-to-import-350-tons-of-gold-1200-tons-of-silver-40594-3-1.html (July 8, 2011).

[3] Peter Koven, *High quality gold deposits becoming more precious*, http://business.financialpost.com/2011/07/07/high-quality-gold-discoveries-becoming-more-precious/ (July 8, 2011).

There has been considerable media coverage of the debt problems affecting Greece and other Eurozone countries recently. We will not rehash all the twists and turns here, but it appears to us that:

-These problems do not come as a surprise. They are one reason why the Total Return Portfolio has been conservatively positioned, with approximately 30% of the Portfolio in cash equivalents as of June 30. We have no direct exposure to these problems, but every stock market investor has indirect exposure, whether they acknowledge it or not.

-There is a significant chance that several weaker countries will have to leave the Eurozone and return to separate national currencies. The timing is uncertain; it depends on how long the political will to keep bailing out the weaker indebted countries persists.

-The Eurozone might have made more sense if it had abandoned some of its weaker members earlier and defended a group of core countries focused around Germany and France. It makes no sense to run out of financial ammunition defending minnows like Greece, Ireland and Portugal if massive economies like Spain and Italy are going to run into trouble and need bailouts. Do the "Eurocrats" really believe there is no risk of that happening? Or are they just short-term thinkers?

-If the Greek debt issues result in an actual sovereign default or other confidence-rattling event, there will be some pain in the market, but much of the distress is already priced into stocks and bonds. For example, Greek two year debt was yielding nearly 30% recently, indicating high odds of default. On the other hand, if any major nations (such as Spain or Italy) start appearing like they will default, we will have to reassess our current moderate level of concern.

-Leading German economist Stefan Homburg recently provided some interesting and amusing thoughts on the Greek crisis in an interview with the magazine Der Spiegel[4]:

> "Homburg: In recent days, I myself have invested a considerable sum in Greek bonds. They will mature in one year's time and, if all goes well, produce a 25 percent return on investment. I sleep very soundly at night because I believe in the boundless stupidity of the German government. They will pay up.
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> SPIEGEL: You are not troubled by moral scruples?

[4] Spiegel Online International, *Top Economist on the Euro Crisis 'The German Government Will Pay Up'*, http://www.spiegel.de/international/europe/0,1518,770673,00.html (July 13, 2011).

Homburg: Since I involuntarily help finance the rescue packages through my taxes, I have no problem with also receiving a portion of the profits. Why should it only be banks and hedge funds that benefit?

SPIEGEL: You are apparently very confident that Greece will also be bailed out if it fails to implement, or insufficiently implements, the austerity measures that are being demanded.

Homburg: Absolutely. Greece is neither economically nor politically capable of sorting out its finances. It will never be in a position to repay the money that it has borrowed up to now. The German government will pay up all the same.

SPIEGEL: And what will happen next?

Homburg: Many politicians have also come to the realization that the path that we are on ultimately leads to national defaults and currency reforms. This process is already irreversible, but nobody wants to say it out loud and go down in history as the one who triggered the explosion. So we leave the bankruptcy to subsequent German governments and, in the meantime, throw good money after bad. Sooner or later, this much is certain, the system will be blown apart by political and economic factors. And, unfortunately, there is a great danger that, when this happens, it is not only the euro that will fall apart, but also the entire EU."

While we do not recommend the purchase of Greek debt, we think Homburg's views are cynical but realistic.

The IEA Releases Oil from Strategic Reserves

In late June, the International Energy Agency (IEA) announced that it would co-ordinate the release of oil from strategic reserves around the world on behalf of its 28 member countries in order to offset disruptions to Libyan supplies. The oil available for release under the plan will amount to 59.83 million barrels.[5]

That sounds like a lot, but it should be put in perspective. Global oil consumption is 89 million barrels per day. The entire amount of the release would only meet 16 hours of global demand.

We think the IEA's intention is to depress oil prices in the short term to spur economic growth. Its actions may also signal a new era of increased government intervention (i.e. manipulation) regarding oil prices. This

[5] Alex Lawler, *IEA trims oil volume planned in release*, http://www.dailystar.com.lb/Business/International/2011/Jul-12/IEA-trims-oil-volume-planned-in-release.ashx#axzz1RqSqVCy1 (July 11, 2011).

move surprised us a bit because the IEA has only collectively acted to release strategic petroleum reserves on two prior occasions in its 37-year history: in 1991 at the outbreak of the first Gulf War following Iraq's invasion of Kuwait; and in 2005 after Hurricane Katrina damaged oil infrastructure in the Gulf of Mexico.[6] Also, Libya's production represented less than 2% of global production before its civil unrest.

The IEA's actions seem a bit desperate, and hint at two possible scenarios, both of which could be true: 1) that the global economy is weaker than generally known and the member nations of the IEA are concerned; 2) that the oil supply picture is very tight globally, perhaps tighter than generally known, and short term attempts to depress oil prices seem necessary.

The IEA's actions do not change our positive long-term views on oil prices or the oil producers we own.

The End of QE2

The U.S. Federal Reserve's QE2, or second round of quantitative easing (creating new money to buy assets from banks and other entities), ended in June. The effects of QE2 are debatable, but it the program did seem to elevate the prices of commodities (undesirable to the Fed) and stocks (desirable). Stock markets, anticipating the end of QE2, sold off heavily in the second quarter. With the global economy showing some signs of weakening, we would not be surprised if QE3 is launched in the fall. We think the global economy is still fragile and the effects of the financial crisis continue to linger.

Portfolio Changes

In early May, we sold Rogers Sugar Inc. for $5.22. We did this because it had already produced excellent capital gains and dividends, but there does not appear to be much potential for the company to grow its earnings over the next 2-3 years. Looking back a couple years, we bought the bulk of this investment for clients at 10 year lows and sold near the ten year high. Usually these types of moves are beneficial when dealing with conservative, mature companies.

In late May, we added to our position in Canadian Natural Resources Ltd. (CNQ) at $40.95. CNQ is now the largest position in the portfolio, with a weighting of approximately 8%. We bought more of the stock because we believe it has been temporarily depressed by short-term issues, such as the serious fire and

[6] Petroleum Insights, *World Watch [IEA Oil Release]*, http://petroleuminsights.blogspot.com/2011/06/world-watch-iea-oil-release.html (July 11, 2011).

subsequent repairs at the company's Horizon oil sands facility. Our long-term production growth thesis on CNQ remains intact.

The CNQ purchase was one of several adjustments to our energy sector holdings. Encana Corp. exited the portfolio at $31.97. While we continue to like the company and its plan to grow natural gas production substantially over the next five years, the natural gas pricing environment has not improved as much as we had anticipated, due to shale gas finds increasing long-term supply. After we sold, the stock dropped several dollars when the company and PetroChina broke off negotiations regarding a major joint venture. At the right price, it may reappear in the portfolio.

We added to our Canadian Oil Sands Ltd. (COS) holdings at $26.23. If you recall our last quarterly edition, we had sold some at $32.74. This quarter we merely repurchased roughly the amount that we had sold at a much cheaper valuation.

We sold some of our TransCanada Corp. holdings in the $42 range ($42.21 and $42.52). We continue to like this company as well. We just felt that the valuation became a bit high in the short term and the funds would be better off reallocated to cheaper investments, like CNQ and COS. We trimmed some Vermilion Energy Inc. as well. Our sale price was $50.21. The stock has done extremely well over the last two years, and we felt that the valuation was getting somewhat high. We continue to hold relatively small remaining positions in TransCanada and Vermilion.

Conclusion

We remain excited by the potential of our investments in the Total Return Portfolio. Although stocks in general have performed poorly recently, we have behaved counter-cyclically, adding attractive investments opportunistically as prices fell. The cash equivalents portion of the portfolio has therefore declined from approximately 30% at the end of Q2 to approximately 20% today (July 13). Some of our recent purchases occurred after June 30, so we will discuss them in depth in our next quarterly newsletter, which will be published in October. Thanks for reading! We appreciate your business!

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