CIBC Wood Gundy

Gains in U.S. Large Caps Offset by Weak Canadian Resource Stocks

We believe the companies we own in the Total Return Portfolio and the High Yield Portfolio have strong return potential over the next several years. That said, our short-term results for the six months ended June 30, 2012 have been frustrating, as our Total Return Portfolio declined 3.38% and our High Yield Portfolio declined 2.1% in comparison to a 3.0% decline in the S&P TSX Composite Index. Over a longer time frame, since inception in December 2008, the Total Return Portfolio has now returned 8.1% compounded annually.[1]

During the second quarter of 2012 (Q2), many of the significant directional moves in North American markets were responses to news from Europe. European policy makers have a choice - they can choose to vigorously defend the existing Eurozone by bailing out countries like Greece and Spain or they can allow the Eurozone to dissolve or contract and have those countries revert to national currencies. They keep deferring that fundamental choice by taking half-measures to support the weaker countries and denying their problems. It is likely that Europe will continue to generate negative financial headlines for the rest of 2012.

It is our responsibility to decide how to respond to those headlines. We are sticking to our time-tested strategy of buying high quality undervalued businesses as longer-term investments. We believe that altering our strategy or reducing our time horizon in response to headlines would only harm our longer-term results. Our strategy does require patience and rarely produces any of the instant gratification many people seek, but we believe it will produce excellent results over longer time periods.

Canadian Resource Stocks

2012 has been a weak year so far for Canadian resource stocks. In both our Total Return Portfolio and our High Yield Portfolio, the gains we saw in many of our large capitalization U.S. holdings were outweighed by the declines in our Canadian resource holdings. Signs of weakness in the global economy have contributed to these declines.

Our Canadian resource stock holdings are exposed to the prices of oil, natural gas, gold, silver and forest products. They are high quality businesses, not speculative “junior” or “penny” stocks with no earnings.

We are long-term bulls on oil and want to maintain exposure to high quality oil producers, even though the oil price will inevitably dip during periods of economic weakness. In our last quarterly newsletter we discussed the possibility that natural gas prices are near the bottom of this cycle. Natural gas prices have actually risen somewhat since then. We also want to maintain exposure to high quality gold and silver producers. To the extent that governments around the world try to reduce excessive debt levels through the creation of new money, gold and silver prices will benefit. Investor sentiment is extremely negative towards precious metals mining companies at the moment, and being a contrarian investor when sentiment is extremely negative often proves to be wise.

Our exposure to forest products in the Total Return Portfolio is through Fortress Paper Ltd., a company that we continued to accumulate during Q2, even as its stock has continued to decline. Fortress is riskier than our average holding, but it also has massive potential upside at these levels. Raymond James analysts have estimated that 2013 earnings per share for Fortress will be $3.87.[2] At today's prices around $14, the stock is trading at less than 4x projected earnings.

Fortress owns several different assets, including a banknote mill in Switzerland, a wallpaper mill in Germany and two pulp mills in Quebec, one of which (the Thurso Mill) is producing dissolving pulp, and one of which Fortress has recently acquired with the intention of converting it into a dissolving pulp mill. We have been closely monitoring the company's progress in bringing the Thurso Mill up to full production capacity. Our understanding is that the mill is now running around 83% of design capacity.[3] It is likely that some investors are taking a "wait and see" approach with Fortress, since the company acquired its dissolving pulp mills recently and lacks a track record as an operator. Our view is that the massive potential upside makes the risk worth taking.

During Q2, we sold out of Pan American Silver Corp., which we held in our Total Return Portfolio, due to a fundamental change in the company's growth prospects. At the time of purchase, we viewed Pan American as an undervalued silver producer that would be able to deliver future production growth, partially due to its undeveloped Navidad project in Argentina. On July 2, Pan American issued a press release stating that proposed new legislation would increase royalties on the project and impose government economic participation in the project. The company also stated:

> "The Company's initial review of the effects of the proposed legislation, when coupled with the current inflationary environment in Argentina, indicates that the increased provincial participation will render the Navidad project uneconomic at any reasonable estimate of long-term silver prices."

Frankly, we did not correctly perceive the political risks relating to the Navidad project. Pan American is a profitable company with several other mines, but we concluded that the absence of the undeveloped Navidad project from the company's long-term production profile invalidated our thesis for owning the stock. It was a difficult decision to make, as the company is far from overvalued at recent prices. After the end of Q2, we reallocated the proceeds from the Pan American sale into an undervalued construction and engineering company that we think will deliver better results in the next 3 to 5 years. We will discuss that investment in a future edition.

Conclusion

It has been a frustrating quarter for us, as several of our key holdings linked to the Canadian natural resource sectors have been a major drag on performance. Occasional bad quarters are inevitable, however, the market's assessment of a company's value can be quite volatile and even irrational in the short run. While some frustration is a natural response to difficult markets, our feelings in the short term are ultimately irrelevant – what matters is the quality of our decisions and actions. We will continue to act according to our conviction that purchasing undervalued high-quality companies for long-term investment will lead to great results.

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[1] All return numbers discussed are taken from the returns of the model account for each respective discretionary PIMG portfolio. These numbers are generated using Dataphile software and individual client's account performance may vary. These numbers are not a promise of future performance. TSX data source: www.tmx.com

[2] Raymond James Ltd., Fortress Paper – Company Comment, June 12, 2012.

[3] Fortress Paper, Company Presentation, July, 2012.