A Major Commitment to Beaten-Down Financials

There are positive trends in some economic sectors in North America, and we are finding undervalued companies in those sectors. As a result, we have been active during late 2012 and early 2013 and have positioned our Total Return Portfolio for greater potential gains.

For example, we made two new investments in the US banking industry during the fourth quarter of 2012 (Q4). As discussed in our Q3 Newsletter, recent data indicates that US housing starts are rising, and US house prices have started to increase in some markets. These improved conditions will help US banks.

Bank of America Corp.

On October 5, we purchased shares of Bank of America Corp. at US$9.52, which we see as an excellent entry point for a multi-year investment. Bank of America now makes up approximately 2.5% of the Total Return Portfolio. Historically, well-run large Canadian and US banks have often traded above 1.5 times their book value per share. At US$9.52, Bank of America was trading at less than half its 2012 year-end book value per share of US$20.24 and well under its tangible book value[1] of US$13.36.

One key reason for this apparent undervaluation is litigation. Bank of America has faced numerous lawsuits during the past several years relating to defective mortgages. A significant portion of this litigation has already settled.

Notably, on January 7, the bank announced a major settlement with US government sponsored enterprise Fannie Mae that extinguished claims relating to loans with an original principal balance of approximately US$1.4 trillion. As part of the settlement, Bank of America paid US$3.6 billion and also had to repurchase for US$6.75 billion certain residential mortgage loans it sold to Fannie Mae that had dropped in value. The bank is still facing roughly US$16 billion in similar claims.[2] This is a large figure, but we see it as manageable given Bank of America's scale – its market value exceeds US$100 billion even at its recent depressed levels.

Putting the litigation aside, there are numerous positive factors to mention. Based on its fourth quarter 2012 results, loan losses and long-term debt are declining, and deposits, brokerage assets and investment banking fees are rising. It also appears that loan growth is starting to happen. If these trends continue and the bank successfully navigates the outstanding litigation, we could see a company earning well over US$1 per share and trading near book value a few years from now. Patient investors should be well rewarded.

Wells Fargo & Co.

Like Bank of America, Wells Fargo is one of the largest banks in the US; however, there are some significant differences between the two companies. Wells Fargo was consistently well-managed in recent years, and it navigated the financial crisis fairly well. As a result, it is facing fewer legacy issues than Bank of America. Wells is now the largest mortgage lender in the US, controlling 30% of the market,[3] and it is the largest US bank measured by market value, with a market capitalization approaching US$200 billion. We purchased Wells Fargo shares on November 30th at US$33. Wells Fargo now represents around 2.3% of the Total Return Portfolio.

Analysts' consensus earnings per share estimates for 2013 are $3.63 giving the stock a forward price to earnings (PE) ratio of around 9 at our cost. Price to book value is currently around 1.2. Wells recently increased its quarterly dividend by 14% to US$0.25 per share, giving the stock a dividend yield of 3% on our cost. In comparison to Bank of America, we believe Wells has somewhat less upside potential and also less downside. We are excited to be shareholders of both companies at this potential turning point in the US banking industry.

Yamana Gold Inc.

Yamana Gold Inc. is a precious metals mining company that we continue to own due to its strong growth potential. Our earliest purchases took place in 2009 and 2010 at $11.06, $11.35 and $10.12, respectively. We have recently been active in the stock again. On October 3, we sold some Yamana shares into a rising market at $18.73 and then sold more on November 13th at $19.75. Taking advantage of the volatility in the share price, we then repurchased a portion of the sold shares at $17.66 on December 7. Currently, the Total Return Portfolio weighting in the stock is around 3.5%.

Cameco Corp.

Cameco Corp. is one of the world's largest uranium producers with mines in Canada, the US and Kazakhstan. Its assets would be difficult for any competitor to replicate. The company's shares have been on our watch list for years. The shares declined sharply in late 2012, and we decided to buy at $17.24 on November 26. On January 15th, 2013 we sold the shares for $21.35, giving us a gain of roughly 24% on the position.

<u>CML Healthcare Inc.</u>

We sold our position in CML Healthcare out of the Total Return Portfolio on January 24th for $7.00 per share. We had been buyers most recently on October 5 at $8.84. The company's business performance has lagged our expectations. We continue to hold a small weighting in this company in our High Yield Portfolio pending a high dividend opportunity to replace it.

<u>Agnico-Eagle Mines</u>

We sold our position in Agnico-Eagle Mines Ltd. on November 14th at $55.02. We had originally purchased the shares in April of 2011 at $63.30. In hindsight, we paid too much for the shares, as our earnings growth expectations were not met. One major factor hurting the company's results during our hold period was the suspension of production at the Goldex mine in Quebec due to rock failure and safety concerns, an event that we did not anticipate.

<u>Manulife Financial Corp.</u>

On October 18 we bought additional shares of Manulife Financial Corp. at $12.49. We have discussed this insurance company in detail in previous editions. By adding to the position, we brought its allocation in the Total Return Portfolio up to over 6%. The stock has been rising recently, in part due to the possibility of higher interest rates. Manulife would actually benefit in some respects from higher interest rates, as it would be able to achieve higher returns on the insurance premiums that it invests in fixed income assets. Manulife is one of our favorite long-term investments in the financial sector.

<u>Canaccord Financial Inc.</u>

On October 19 we added to our position in Canaccord Financial at $5.14. We originally purchased the company's shares on February 14, 2012 at $9.10. After the latest purchase our average cost is $7.12, and the shares were recently trading close to $7.50 after a major rally to start 2013. According to analysts' estimates, Canaccord could earn around $0.81 per share in its next fiscal year, which begins April 1, 2013.

Our opportunity to reduce our average cost at $5.14 may have arisen due to tax-loss selling by other investors.

Fortress Paper Ltd.

Although we did not transact in shares of Fortress Paper during Q4, the company is worth addressing in this newsletter, as its shares have dropped substantially. The company's current weighting in the Total Return Portfolio is just over 2%. We continue to view the shares as a good long-term investment, despite the operational difficulties experienced by the company.

According to the company's January 25 press release, one of the mills, the Fortress Specialty Cellulose Mill, continues to encounter challenges in ramping-up its production to full capacity, despite good results in November and December. The company also announced that its cogeneration electricity project at the Fortress Specialty Cellulose Mill is 94% completed and subject to some delays and cost overruns before its projected completion in a few months. Due partly to disappointing news like this, the shares are trading well below our cost. Based on current information, patience is our best option.

Encana Corp.

On November 14 we sold out of our investment in Encana Corp. at $20.90. We had originally purchased the shares in March, 2012 at $20.63. We collected a 4% annualized dividend during the hold period. Our views on a natural gas pricing rebound have moderated slightly. We will continue to follow this high quality company.

Aecon Group Inc.

On November 13th we sold our investment in Aecon Group Inc. at $10.36. Our original purchase price was $8.79 on February 11, 2011. We continue to have exposure to construction and engineering through SNC Lavalin Group Inc., discussed in our Q3 2012 newsletter.

Conclusion

We are excited about the holdings in our Total Return Portfolio and High Yield Portfolio. New purchases during the opening weeks of the first quarter of 2013 (Q1), which we will discuss in our next quarterly newsletter, have added to our upside potential. Although we were not active in the High Yield Portfolio in

Q4, we have made new investments in Q1. As always, we thank you for your business, and invite you to contact us with any questions or comments.

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[1] Tangible book value per share is book value per share minus intangible assets like intellectual property and goodwill.
[2] Slide 17 of Bank of America's Q4 2012 Presentation indicates GSE claims post-FNMA settlement at US$1.3B, Private claims at US$12,299B and Monoline claims at US$2,449B for a total of 16,048B of outstanding claims.
[3] Associated Press, *Wells Fargo's Net Rises, But Mortgages Slow*, http://finance.yahoo.com/news/wells-fargos-net-rises-mortgages-slow-153428837--finance.html (January 24, 2013).