Small Cap Update

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Christmas Cheer

Open your presents at Christmas time but be thankful year round for the gifts you receive

\- Lorinda Ruth Lowen

Although 2009 had a miserable start, capital markets have been in a gift giving mood for most of the year. Near zero interest rate policy combined with unprecedented global fiscal stimulus resulted in assets catching a bid. A year ago at this time, companies with excessive debt were at risk of going bankrupt. Today access to capital is abundant. This week alone, I am having difficulty counting on one hand all of the Canadian Real Estate Investment Trusts that have come to market to raise funds. Even Dubai World, the poster child of excessive borrowing in the credit bubble now appears able to refinance. To top off the twelve month turnaround in equities, Time Magazine has named the stock market's Santa Claus; Federal Reserve Chairman Ben Bernanke "person of the year", crediting him with keeping the economy from falling into an abyss.

We fully expect that "Santa Ben's" sleigh will not be as full at this time next year. With the global economic outlook and the functionality of financial markets improving, most of the Federal Reserve's special liquidity measures are expected to expire on February 1st. Other measures are expected to be scaled back throughout the year. How the market handles this transition is the major question for 2010.

Despite the macro uncertainty, we still believe the fund is invested in numerous attractively valued high quality businesses, fit for the QV Christmas stocking.

Inside the Fund

Empire Company recently released their quarterly results. Empire's key businesses include food retailing and related real estate. They are one of the largest grocery store operators in Canada, with a platform of over 1,300 Sobey's, IGA, Thrifty Foods and Price Chopper stores across Canada. Revenue for the quarter increased 4.0% and operating income increased 12.0%. They are generating cash flow in excess of their capital requirements. This has allowed Empire to increase their dividend for nine consecutive years. They have also continued to build their business during these trying economic times. Two year's ago their book value per share was $35.02, last year at this time it was $37.65. Today it stands at $41.27. Despite continued operating success Empire shares have declined in value over the past year. From a valuation perspective Empire is currently trading near the low end of its historic valuation range. The combination of book value growth and dividend growth underpinned by attractive valuation are powerful contributors to shareholder returns over time. It is one of the largest weights in the fund going into 2010.

Transcontinental Inc. reported year end results earlier this week. Transcontinental provides printing, publishing and marketing services. They are the largest printer in Canada and sixth largest in North America. The printing industry has been under assault for a number of years as more and more traditional print advertisers move online.

Despite industry difficulties we believe Transcontinental's focus on niche end markets while maintaining some of the most advanced printing assets in the industry will allow for continued value creation. Their financials support this. In possibly the worst year the printing industry has ever faced, Transcontinental's profit margins have only declined by 3/10th's of a percent. Despite the decline, their profit margins remain higher today than ten years ago. Their performance compares very favorably to their largest competitor in Canada who has had to file for bankruptcy in the past year. Their business model also looks extremely resilient compared to newspaper publishers. One of the world's most recognized newspapers, the New York Times, has seen their profit margins shrink by approximately 70% over the past decade.

Although Transcontinental exhibits a strong financial track record, we believe this is not being recognized in the stock price. The company reported $1.61 in earnings from operations for the full year. The stock price closed at $13.00 today, implying a trailing price-to-earnings ratio of approximately 8.0x. This is a nice discount to the small cap fund's current P/E of 13.3x and the S&P/TSX P/E multiple of 14.5x. If Transcontinental can maintain its track record, we expect this to deliver outsized returns in 2010.

We will return with our weekly email on January 8th. We wish all of our readers a safe and happy holiday season.