

## Market Outlook

"We believe the S&P 500 will close out the year at 1320 ..." This is a recent quote from one of the typical market outlooks one finds at this time of year. Exactly how do you get a target of 1320 on the S&P 500? Easily, you speak confidently, throw around a bunch of numbers which can't be outright disputed and pretend your formulas are scientifically based. For those of us involved in giving advice in this industry you know the importance of having an outlook. It often doesn't matter if it is right or wrong you just need a point of view.

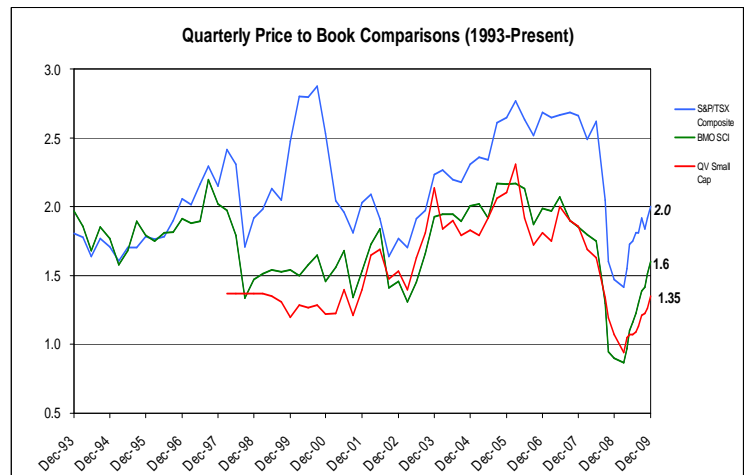
Our outlook today, but we reserve the right to change it tomorrow, is the market may go up or down! Hold on before you click us off the screen. Isn't it interesting how honesty leaves one feeling insecure, yet some half-baked positive prediction gives people a feeling of safety and optimism.

Our facetious prediction is based on the work of the highly respected Ned Davis Research which we subscribe to. They did a piece recently where they played with some historical numbers. These numbers were just averages and not certain to repeat, but we investors try to give ourselves some guidelines to live by. Their recent study was on market odds at various stages of the stock market/economic environment. They studied the five prior bull markets since 1975 associated with the end of a recession. What they found was that in the five cases from the end of the bear market to the end of the recession, the S&P 500 rallied on average by 27.5%. During these same five periods the average downside was just over 5%. Dividing the 27.5% by the 5% gave approximately 5 to 1 historical odds of market upside.

They did the same thing during the period from the recession end (sometime last summer) looking out six months later. In that period they found the average upside of around 16% and downside of around 9% for a favourable 1.75 to 1 odds of a gain. The last piece of their analysis focused on the returns 18 months after the recession end, which is the equivalent of the 2010 calendar year period. They found an average gain of 13.3% and an average loss of 13% for a risk/reward ratio of 1. The conclusion, the market may go up or it may go down that's what over 30 years of cycle data is telling us.

We get more from this piece than just our flippant conclusion. The data just confirms that your best odds of positive returns have historically been when things look worst. As they get better the odds quickly become challenged as your ability to find good value is reduced. The challenge for all investors is the same today as it was last year and as it has been for all of history. Buy low - Sell High.

It is currently more difficult to find undervalued securities than it was a year ago. That being said, we have raised very little cash as we find the majority of our holdings represent reasonable value. They will likely fall and rise with market volatility but the key for us is their ability to continue to survive and grow their franchises. Our chart below tracks our Fund's Price/Book Value relative to that of our benchmark BMO Small Cap Index and the S&P/TSX Composite. This goes back over ten years and shows that last year small companies on average traded at about a 10% discount to book value. You can see the rapid change in a very short period of time. Our portfolio remains with favourable valuation characteristics relative to this benchmark.



The Fund P/B is 1.35 times, the small cap benchmark is 1.6 times and the S&P/TSX Composite trades at 2.0 times. Granted this is only one valuation measure, we suggest the valuation opportunity remains favourable relative to the broad market. Just because we are dubbed small cap does not mean there exists any greater risk in this portfolio today than that of other asset classes. Let us share one little trading tidbit we just experienced. The other day we got a call that there was a large seller of Canam Group which we hold. Canam trades at 0.8 times book value, 6 times cash flow and has a 2.25% yield. The seller was switching into a company called Lake Shore Gold. We thought "Why would anyone sell Canam at this discount?" so we checked out the financials on Lake Shore. The company trades at 3.0 times book value, 99 times cash flow and has no dividend. The shares are up nearly 120% in the past 52 weeks, Canam on the other hand is flat. Nobody cares about a 2.25% yield and book value when you can buy junior resource stocks which are surging. As investors we should care. The same way the best time to buy into the stock market was when nobody wanted to the best opportunities today are in those companies which are being ignored.