First Quarter 2012 Investor Letter

The market has favored growth stocks since late 2011 when portfolio managers believed that the worst from Europe was over and that the US economy would outperform the rest of the world. With the idea that the US economy was bottoming in late 2011, portfolio managers have been buying technology and consumer discretionary stocks (especially retail), sending those sector higher. Our portfolios performed well during January (+7% on average) and much of February (+4% on average). However, the last day of February and March were a challenge as commodity stocks, which make up the bulk of our portfolios, suffered from a further rotation into growth/technology stocks due to fears of a Chinese slowdown and better US economic fundamentals. Many stocks with poor fundamentals did well in the first quarter because portfolio managers wanted economically-sensitive stocks, which boosted financials and consumer discretionary stocks. We have stayed with most of our positions believing that much of the better economic data was transitory; however, investors have favored growth over value, and our positions have not recovered so far in April. We will be looking to limit further downside risk in May if investment trends do not reverse, but over time, history has proven that value investing has consistently provided better returns than growth investing.

First Quarter Market Conditions

The first quarter of 2012 was characterized by slightly better economic statistics in the US and the lessening of “all Europe, all the time” financial coverage that characterized last quarter.

January was an “up” month, which many see as a precursor of an “up” year. Stocks jumped right out of the gate with a big first day of trading (up 2-3%) and never looked back. The S&P 500 was up almost 4.5% with materials, financials and technology companies leading the way, while utilities, telecoms and consumer staples lagged. Precious metals rebounded strongly from their December sell-off, while energy was volatile but energy stocks ended up while crude prices were unchanged for the month.

February was a slightly muted repeat of January, although there was a lot of intra-month activity in most sectors. The S&P 500 gained over 4%, with technology, energy and financials again moving higher while materials, health care and utilities lagged. Materials stocks had a very good month until they were crushed on February 29th with a

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large suspicious gold trade (see more below) coupled with the lack of any mention of easy money policies during Fed Chairman Bernanke's semi-yearly congressional briefing. Also on the 29th, the European Central Bank (ECB) completed the second leg of its Long Term Refinancing Operations (LTROs) with almost €600 billion of three-year loans to roughly 800 banks across Europe – including a large number of German banks. Crude oil prices advanced as Iran/Israel concerns grew more dire, and the market grew worried about the European ban on Iranian imports. Natural gas, on the other hand, hit new multi-year lows as the lack of a normal North American winter and rising deliverability from shale plays worsened the supply/demand fundamentals. In other markets, the Japanese yen weakened from multi-year highs, as both the Bank of Japan and Japanese Finance Ministry spoke out against the strong yen. We see the yen falling over the next few years as demographic, financial and political factors combine to put pressure on the currency.

March showed divergence, with materials suffering from the late February attack, while many consumer and technology stocks continued to move higher (led by Apple, Amazon and Google). Financials led the way higher in March, after the European LTROs, combined with the US Fed's stress tests of big banks (which did fail some large banks, including Citibank), convinced market participants that the financial situation was continuing to get better (see more below). Technology also continued to rise, in large part due to Apple's runaway share price (up nearly 50% in the first quarter). Energy, utilities, materials and industrials were laggards as concerns about China's slowdown took its toll on these sectors which provide inputs for Asian growth. As mentioned above, precious metals were punished during the first part of March as traders saw few catalysts to take them higher, but late in the month, the metals turned around as easier monetary policies were anticipated in the US, Japan and China. Energy prices fluctuated but stayed roughly at February levels. Fixed income prices were a large focus during the month, with longer-term Treasuries showing some weakness and yields rising over 2% for US 10-years and over 3.25% for US 30-years. The yen continued its weakness from February.

Precious Metals

After the extreme weakness of December, precious metals rebounded strongly in January, outperforming most other investments, as some evidence of worldwide economic recovery showed up in economic statistics. In February, metals continued to advance in price as demand stayed steady and the second leg of the European LTRO was held. However, on the last day of February, a large block of gold (31 tonnes, or nearly 1 million ounces) was dumped on the market, causing prices to plummet. The weakness continued into March, as technical traders sold the metals and analysts followed with lowered estimates for gold mining companies' earnings. Market participants' doubts about the Fed's implementation of more quantitative easing also caused some traders to sell their gold and silver. This was one of the periodic sharp drops in price that

characterize commodity markets, and this time gold and silver suffered from market skittishness and the attractiveness of other investments, most notably US tech stocks.

The mining stocks suffered along with the metals themselves, and the drop in the stocks was worse as market watchers worried about rising costs of mining due to high energy prices, labor unrest in some mining districts and political instability (specifically Randgold, which suffered from a March coup d'etat in Mali in central Africa). These worries, coupled with weak precious metals prices, led to a horrible March after good gains in January and much of February.

Energy

The energy complex remained strong for much of the first quarter, with Brent (North Sea) crude staying in the $115 – 125/bbl while West Texas Intermediate (WTI) crude traded at a discount, starting the year just under $100/bbl and vacillating between $100 and $108 for much of the quarter. WTI continued to trade at a large discount because so much WTI was produced in the central US and Canada but was unable to be transported to world markets due to pipeline constraints (supplies located at the end of the pipelines). This pricing structure hit some of our Midcontinent and Canadian oil sands investments as their realized prices were much lower than worldwide crude prices. The price discrepancy is being solved by pipeline reconfigurations (two crude oil pipelines are being switched to transport crude north to south, changing their initial south-to-north transportation routes) and new pipeline construction (including the Keystone XL pipeline causing such a debate in Washington and Nebraska). We believe our investments with long-lived crude reserves will reap the benefits of high crude prices as early as next quarter when pipeline reconfigurations take effect.

Other Markets

Longer-term bonds, last year's outperformers, were stable for much of the quarter but showed weakness in March as economic statistics reflected some nascent economic strength. European bonds were calmed by the huge LTRO loans (at least temporarily), pushing them from the headlines.

International equity markets, huge underperformers last year, recovered some of their losses from last year, ending the quarter, in many cases, with double-digit gains.

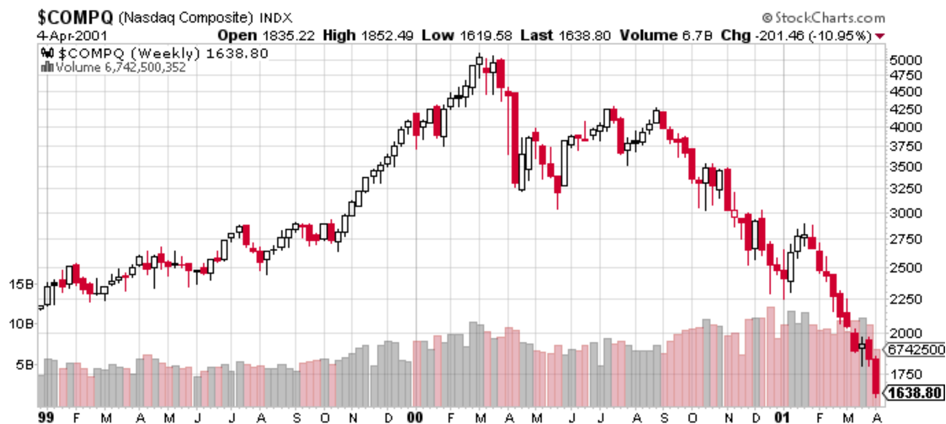
Kanos Quarterly Commentary

Now is the *Spring* of Our Discontent

The title of our commentary is a slight twist on a famous phrase from Shakespeare's Richard III. "Now is the winter of our discontent" is the opening line of the play which lays the groundwork for the portrait of Richard as a discontented man who is unhappy in a world that hates him. The quote is apropos because commodity stocks have underperformed in an environment tailor-made for them. This underperformance reminds us of a recent time, discussed below, when notable underperformance by excellent stocks also led to a bad few months for value investors.

In the spring of 2000, hundreds of companies were selling for extremely high valuations based on their projected growth rates and investors' experiences with the then-recent huge gains in technology-based stocks. What few investors remember, but value investors are well aware of, was that more traditional value stocks were selling at mind-numbingly LOW valuations during the same period.

Numerous examples of this situation existed. Some of the most noteworthy were: 1) Berkshire Hathaway, run by Warren Buffett, with decades-long successful track record of investing, dropped to a three-year low in March 2000 (from $80,000+/share to just over $40,000/share) [see first graph below] while the Nasdaq roughly tripled over the same time frame [see second graph below];



2) Caterpillar, the premier construction equipment company in the world that was benefitting from the building of warehouses, offices and infrastructure of the "new economy" fell from (a split-adjusted) $26/share in mid-1999 to just over $14/share in March 2000; and even 3) McDonalds, far from an "old economy" stock (people do have to eat, even in technology companies), reached a high over $40/share in November of 1999 and dropped to near $24/share in March 2000. All of these stocks rebounded once the fascination with tech stocks was extinguished, although some went back near their highs (Berkshire) and the others, after rebounding during later 2000, took a few years to get to new highs.

The extreme disconnect between value and growth occurred when traders/investors had to own the "hot" names and shun things that were "out of favor." Part of this phenomenon is attributable to greed, part to fear. The greed component came from "analysts" and other market participants projecting exponential growth for tech stocks and their stock prices rising to the sky. It had happened to a number of companies, so people continued to try to pick new winners and to add more money to stocks that were rising. In addition, as indices and other benchmarks rose during 1999/2000, professional money managers were forced to buy volatile technology stocks in order to keep up with their benchmarks or miss the biggest bull market of their careers. This "career risk" is a little-referenced driving force in bull runs these days; the easiest way for a money manager to get fired by his firm is to miss THE bull market – even if it means taking on lots of risk. Unfortunately, if the risk pays off, the manager gets paid handsomely (and the investors make money). However, if the position loses, the risk hits the investors hard as they lose more due to the higher risk.

These examples illustrate what has happened to some of the stocks in our portfolios, namely the precious metals mining stocks. They have gone from market outperformers (last summer when they rose during the US debt ceiling/downgrade market swoon) to market pariahs (this March). Why has this happened? A number of factors appear to have affected this sector: 1) their outperformance attracted a number of "hot money" holders who sold their holdings when corrections occurred during the past nine months,

2) the improvement of economic conditions in the US over the past few months has convinced some investment managers that a new bull market is underway (even though the improvement has been relatively small in scope and has not enabled the slow recovery from recession to become self-sustaining), 3) the momentum of a number of technology stocks that have found a euphoric pocket of investment and caused a number of these stocks to far outperform the market (led, of course, by Apple, but also IBM, Salesforce.com, Google and others) and 4) the "career-risk" where managers must participate – in this first quarter bull run, managers added more Apple and Salesforce over the months to catch up with the benchmarks, propelling those stocks to 50% gains in three months that far outstripped their fundamental results.

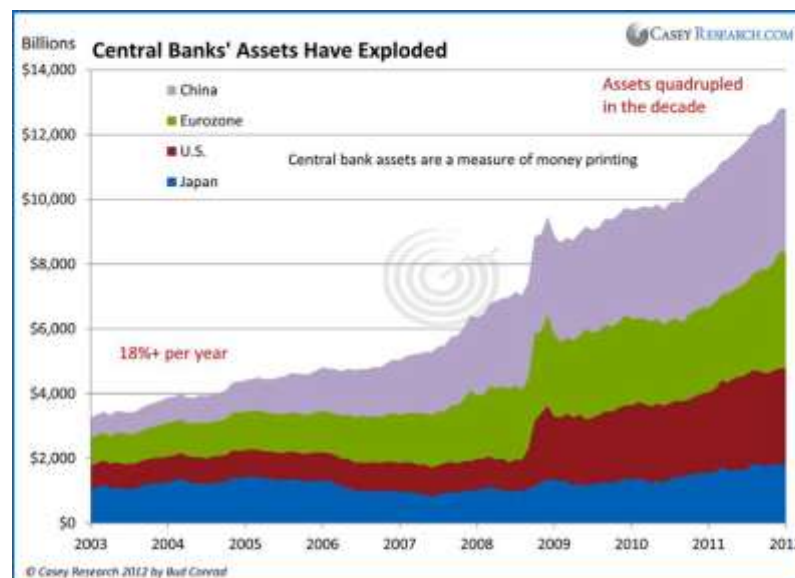
Aware of all of these factors, we continually examine the economic and market conditions in the US and world, evaluate the possible outcomes of various investments on a going-forward basis, evaluate our positions and the sectors Kanos customers currently own, and check our portfolios to see whether any changes need to be made. We believed that Kanos' outperformance in January, market performance in February (until a big drop on "leap day"), and a flat stock market in March would bring more investor interest to undervalued commodity stocks, especially in metals mining. Investors have instead shunned these investments, while our analysis indicates that value investors should be more interested. The rest of this piece will be devoted to the outstanding fundamentals underlying our investments and the conditions that may influence them and the markets going forward.

So what are the reasons that underpin why we have stayed with a commodities-based portfolio, with a large emphasis on precious metals and precious metals mining stocks? While some of this may be reiteration from past letters, it is so important as to bear some repetition:

1) The weakness in worldwide economic activity and the willingness of the world's central banks to promote easy monetary policies: While the Fed has not instituted a new round of quantitative easing, many other central banks have – Europe issued its second round of LTROs in late February with the net amount being larger than expected (around $500 billion) and used by many more banks than expected (800+ European banks). The Bank of Japan instituted new measures in mid-February to fight deflation and to expand its balance sheet **[late note: and again in late April – another $123 billion]**. China's central bank lowered its reserve requirement for banks on February 19 (for the second time in three months after three years of raising them), freeing up more liquidity for its economy. Even Switzerland has pumped more liquidity into its banking system, defending the Swiss franc from further appreciation against the euro. All these measures mean more world liquidity, signaling to many that high supplies of paper currencies point to more demand for hard assets, especially precious metals and essential commodities like oil.

Although the Fed has not changed its policy lately, the three most powerful members of the Federal Reserve Open Market Committee, Chairman Bernanke, Vice Chairwoman Janet Yellen and Federal Reserve Bank of New York President William Dudley have all given speeches in the past few weeks that have emphasized that the Fed is willing to act to inject more stimulus if conditions warrant. We believe conditions in Europe and a still-sputtering US economy will provide those conditions during 2012.

The graph below, from Bud Conrad at Casey Research, graphically shows the rise in central bank assets, which has accelerated since 2008.



2) <u>Negative real interest rates resulting from easy monetary policy</u>: Measured inflation is running over 2.5% for much of the developed world and higher for some developing countries, but interest rates are pretty much near zero. **<u>Thus, cash is not earning enough to offset inflation, and cash balances are shrinking in purchasing power by 2.5% per year.</u>** People with low income or fixed incomes feel this acutely – everything costs more but you have the same amount of dollars. This eats away at people's standard of living or causes them to borrow more to support their current lifestyles. Thus, savers' who want to preserve their wealth in times of negative real rates' look to assets that will hold their value: metals, commodities, art, jewelry are all historical examples of stores of value; lately, US investors have also projected US stocks to be a place to store value and reap dividend income.

3) <u>The large overhang of debt worldwide, especially sovereign debt</u>: With the Fed's mandate to support growth/employment in addition to its price stability mandate, Chairman Bernanke continues to be under pressure to help raise employment – he has tackled this problem with low interest rates (both short-term, by setting a low

Fed Funds rate and long-term, by buying long-term Treasuries, thus lowering their yield). **In fact, it's been calculated that the Fed bought so many Treasuries that it is the equivalent of 61% of long-term Treasuries in 2011.** We believe the Fed will continue what they consider a successful policy, especially as the Treasury must issue larger and larger amounts of Treasury bonds to fund the huge budget deficit. Of course, this is also happening in Europe and Japan. The LTROs were a form of a way of supporting government debt auctions – the ECB "sleeved" the transactions by lending to European banks and having them buy the debt. Japan expanded its program to buy Japanese Government Bonds (JGBs) on February 14, applying another $129 billion to its JGB purchasing program, trying to stamp out the deflation partially caused by the large debt balances outstanding in the country **[and announced another $123 billion bond-buying program in late April].**

4) Extra value in commodity stocks: Commodity stocks have underperformed lately as investors have discounted higher production/energy prices, increasing wage pressures and risk of nationalization/political instability in some countries. However, many large commodity companies have improved operations since the demand shock of 2008 in order to weather poor pricing environments, and many have shown improved margins in spite of investor pessimism. In addition, rising commodity prices may lead to higher margins (providing positive margin leverage), while resources in the ground may become economic at higher prices, allowing more to be classified as reserves and adding to the recognizable value in commodity companies. These conditions are true in metals miners, oil & gas exploration and production companies and even fertilizer companies. The table below, assembled by metals authority James Turk, shows the historic ratio of gold grams needed to purchase one unit of the Philadelphia Gold and Silver Index, an index of precious metals mining companies. The graph is an illustration of the current undervaluation of gold miners to the current gold spot price.

5) Central bank activism coupled with political inaction and uncertainty: Central bankers have been activists in the US, Europe, Britain, Switzerland, and to a lesser extent, Japan. Since 2009, central bankers have led the policy initiatives to fight deflationary and recessionary forces. As epitomized by Ben Bernanke (who has always favored policies of easier money), we believe these central bankers will continue to exert monetary policy as the only viable policy tool – which means more money creation. Political inaction caused by elections (the US, France and in a different twist China [elections by the Politburo] means that regime uncertainty will not allow fiscal action. The economic crises afflicting southern European countries, coupled with political instability in Africa (coup in Mali) and the Middle East (unrest in Syria and Egypt) and the leftward political actions in Argentina (nationalization of oil company YPF) and Brazil (left-leaning President Rousseff has been much less business friendly than predecessor Lula) portend nervous capital and skittish investors. Investing in undervalued resources that are needed worldwide and that can only be acquired with experienced management and a majority of resources located in politically reliable areas of the world should be worth a premium to equity investors.

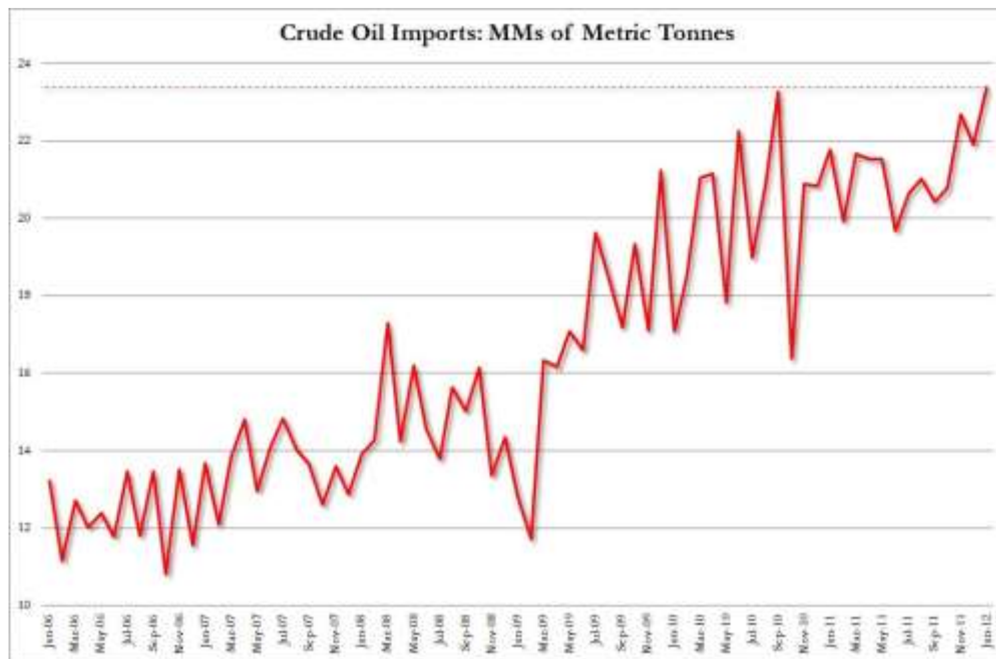
6) And finally, central banks and Asian investors continue to want to buy physical gold, leading to more consistent demand: Central banks were net sellers of gold for the last several years through 2009, but many are continual buyers now. China has been a buyer of virtually all the gold produced in-country, although they only periodically announce their gold reserves. However, in March alone, a number of central banks bought large amounts of gold for their reserves: Russia (16.5 tons in March after a small sale in February), Mexico (16.8 tons), Turkey (11.5 tons), Argentina (7 tons), Kazakhstan (4.3 tons) and many smaller banks. Even the Eurozone as a whole was a net buyer of gold in March (although the net purchases were only a couple of thousand ounces). Indian demand is picking back up after their March strike, and Chinese retail demand has been rising due to factors like those described by famed commodity investor Jim Rogers in an April interview with HardAssetsInvestor.com: "…I know China has a campaign encouraging the Chinese citizens to own gold. I know [gold] shops have sprung up everywhere. And good banks are now offering gold everywhere. So there's been a huge change in China over the last five years."

Don Coxe, former equity strategist at BMO Capital Markets and still affiliated with the firm through his own firm, Coxe Advisors, has had almost 40 years of investment experience, mostly with equities and commodities. Coxe recently remarked, **"In our view, we have entered the most favorable era for gold prices in our lifetime — and the share prices of the great mining companies will eventually outperform bullion prices**," in the March 2012 edition of his periodic investment newsletter *Basic Points*.

If commodity fundamentals are so favorable, how come prices have been weak for precious metals and for almost all commodity stocks, energy and agriculturals included?

1) Fear of deflation: While central banks have created a lot of liquidity over the past couple of years and the European Union, along with the IMF, have set up bailout funds to help European economic problems and debt overhangs, the investment world is not fully convinced that enough money has been created to reverse deflationary forces. Deflation occurs when the value of assets decline relative to money. Deflation can be exacerbated by price declines in assets financed by debt, because the leveraged equity supporting the asset declines much faster in value than the asset itself. That is what investors and traders are so concerned about in Europe – loans, including government loans, are losing value as confidence in repayment falls, especially after the Greek default, and liquidity is considered king. Many of these government bonds, as well as loans on real estate assets (down after the burst real estate bubble), are financed on leveraged bank balance sheets. This leads to major concerns that these banks will have to be bailed out by governments, resulting in higher leverage on sovereign debt and leading to serious doubt about repayment of southern European sovereign debt, with Spain and Italy at the forefront of these concerns. While we believe that these deflationary forces are strong, we also believe that the ECB, European Union and IMF will continue to bring monetary assistance to the table, thereby diminishing the nominal problem by using inflation to lessen repayment risk. The US faces the same problems to a lesser extent; large budget deficits will need more debt to finance them, and the Fed will eventually foster more inflation to diminish the nominal repayment problem. All of this should help blunt the forces of deflation and should be favorable for commodity prices, especially monetary commodities like gold and silver.

2) Dependence on Asian demand: One concern about commodity demand is the large amount of demand that comes from Asia. Part of the swoon in precious metals was the effect of the gold sellers' strike in India during March; this strike severely crimped Indian retail demand, which helped weaken the price of precious metals during the month. The same phenomenon is true of energy, especially oil, in China – Chinese demand is second only to the US in oil usage, and any hiccup will lead to price weakness in oil. However, you can see from the graph below (citation unknown), Chinese crude oil imports are strong and have continued to grow into 2012 in spite of fears of a Chinese "hard landing" for its economy.



Going Forward

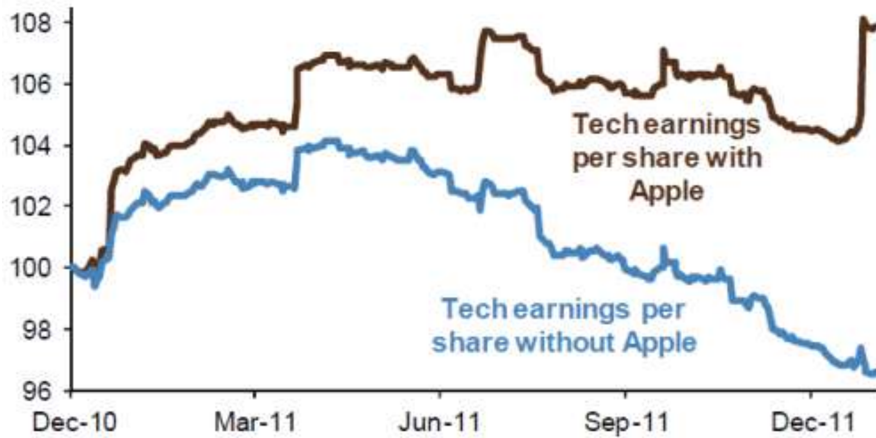
Equities

We are concerned about the stretched nature of the US and many foreign equity markets after stellar first quarter performances. We are also looking at our equity portfolios and determining whether we need to cut positions (that we still find attractive) for risk management purposes and to raise liquidity. We will evaluate this on an ongoing basis, but we would like to stay with attractive, undervalued equities as long as possible.

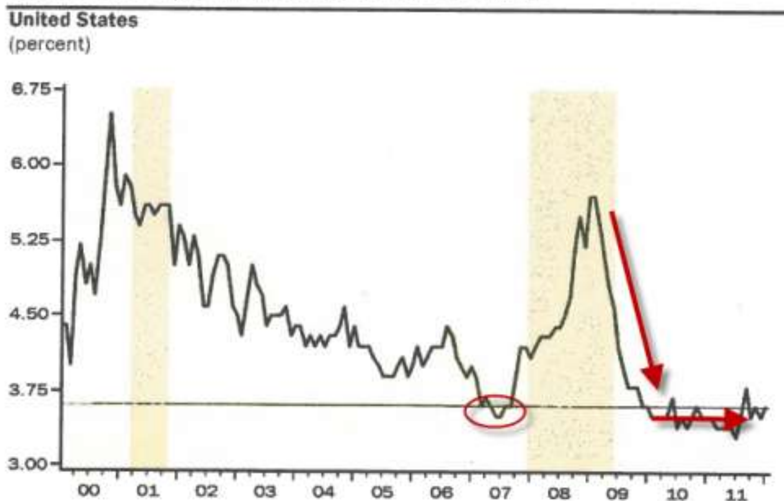
Our portfolios underperformed in the first quarter because of late February/March weakness in precious metals pricing and mining share performance. We are very concerned about the price action and believe that the market's outperformance by growth stocks is due to factors that we believe to be transitory. Meanwhile, we continue to look for attractive, dividend-paying investment possibilities in which to redeploy capital.

We believe that much of the equity move in the first quarter was short-covering of financial and formerly poorly-performing cyclical stocks like consumer durables and consumer discretionary. The deteriorating economic statistics in April may show that investments in such stocks may prove to be less profitable than in the first quarter. Technology may be one area where there could be some serious corrections; the graph below from FactSet and Barclays Capital shows tech earnings with and without Apple.

We would not be surprised to see some serious earnings disappointments announced in the coming months.



Another chart [see below], from Canadian asset manager Gluskin Shelf's chief strategist David Rosenberg, shows that there is little "cash on the sidelines" as claimed by a number of equity market bulls. In fact, it seems that the majority of that liquidity was deployed in 2009 when investment managers had to jump on the "performance train" as the equity markets rose strongly off the March 2009 bottom.



The bull run that stocks have seen has led to much higher valuations than last fall's bottoming. A number of sectors that some considered bargains last fall, like consumer staples and industrials, no longer seem as attractive. We would like to own more pharmaceutical stocks, but we would like to see the results of the Supreme Court's decision on the constitutionality of ObamaCare (due out in June 2012) before committing too much new capital. Utilities, while an attractive investment theme and an area of interest for us, are vulnerable to higher interest rates, which we believe could occur during 2012, so we will also be cautious before committing too much money to the utilities sector unless first there is a downdraft in share prices.

Precious Metals

Our views are mostly covered in detail in the Kanos Commentary section. However, we thought it was interesting to include two opinions on commodities by well-known, non-commodity-oriented investors.

The commentary of John Hussman from the Hussman Funds on one of his mid-April Weekly Investor Updates states:

> "In [the] Strategic Total Return [Fund], we raised our exposure in precious metals shares to about 12% of net assets in response to recent price weakness in that sector. The ratio of gold prices to the XAU is now nearly 10-to-1, which is close to a record high. Historically, gold stocks have been treated as having "insurance" features, and their negative correlation with other stocks was accompanied by premium valuation multiples. At present, many precious metals shares have higher yields than most S&P 500 stocks, and are also significantly depressed relative to gold prices, which suggests a relative margin of defense even if gold prices were to decline substantially. This sector still has substantial volatility, which is why our exposure in terms of net assets is not aggressive (though we would likely increase that exposure on significant economic weakness). Overall, we're comfortable shifting to a moderately higher exposure in this sector, recognizing that we may observe additional volatility as market conditions change."

We couldn't agree more with Mr. Hussman.

Second, in his April Commentary titled "The Great Escape: Delivering in a Delevering World", "bond king" Bill Gross of PIMCO, who manages the world's largest bond firm, believes that the Fed (and most other central banks) have lowered interest rates as far as they can (the "zero bound"). Thus, interest rates will eventually head up, meaning levering up financial assets will no longer produce returns. He adds, "Commodities and real assets become ascendant, certainly in relative terms, as we by necessity delever or lever less." Gross' investment advice going forward includes: "For bond markets: favor higher quality, shorter duration and inflation protected assets…For commodities: favor

inflation sensitive, supply constrained products." That dovetails with our thinking and is why we hold gold (inflation sensitive) and oil (supply constrained) investments.

Energy

Energy continues to be attractive from fundamental and valuation perspectives. We've concentrated on Canadian and US domestic crude oil producers, which have benefitted some from higher prices but have suffered from the discount US domestic oil (and Canadian oil from Alberta and the oil sands) has seen due to surplus deliverability and lack of transport to Gulf Coast and East Coast refineries/export outlets. We believe those constraints are in the process of being worked out and that the domestic producers will see uplift in realized prices, profits and trading multiples on their stocks. **[Late update: in late April, high quality Canadian Syncrude returned to a premium over WTI crude oil pricing].**

We believe natural gas, while seemingly near a bottom in prices, may not achieve its bottom until next fall when natgas storage is full and production is rationed by demand. We believe this could be the multi-year bottom in natgas as more power plants and vehicle fleets come online to burn natural gas starting next year, coupled with more normal winter weather and heating demand. Also, low natgas prices have started to attract industrial companies to build plants and plant expansions to take advantage of cheap energy prices. New industrial demand could also spur natgas prices, but by mid-2012 at the earliest.

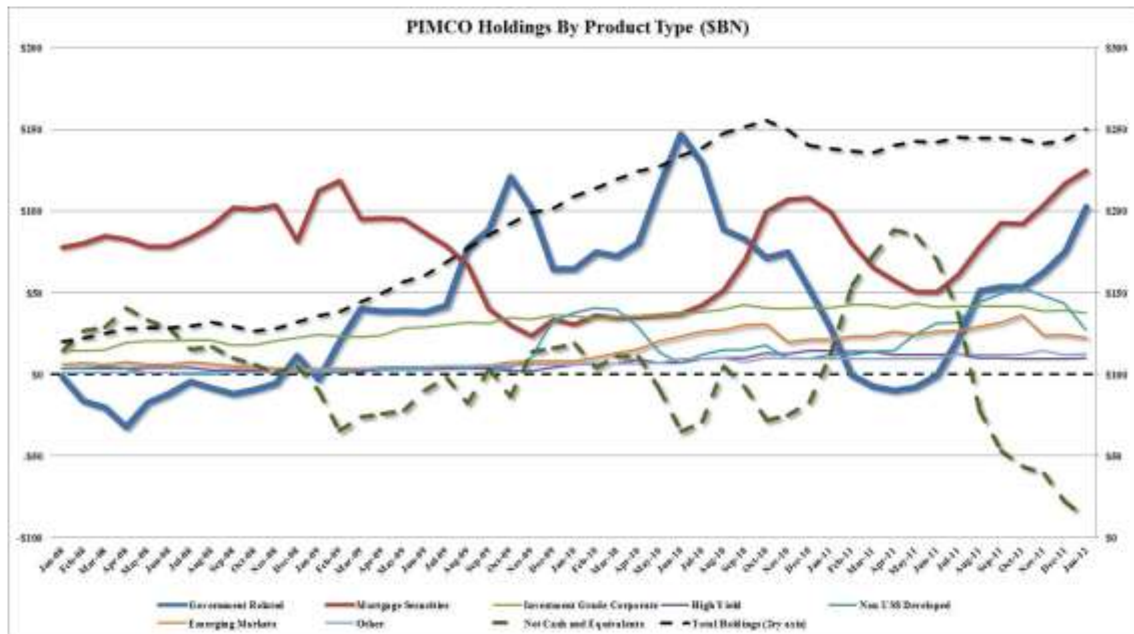
We do believe that there is one aspect of the energy complex mostly ignored by the media and financial analyst community. Much has been written about the increases in production of the US oil and gas shale plays and the technological advances that have allowed more petroleum to be extracted from deep offshore wells. However, the inevitability of production declines from the majority of the world's wells, especially since virtually all of the largest oil fields have past their peak production, means that prices may stay higher than most investors think due to high demand and increasingly expensive and difficult-to-produce new sources. The world has not been replacing its crude oil reserves over time, according to oil trader extraordinaire and president of Phibro Trading, Andrew Hall, and he believes that will lead to even higher oil prices in the future. Even a recession in 2013 around the world may not take down stubbornly high oil prices very much or for a meaningful amount of time.

Other Markets

Fixed income prices showed some weakness in early 2012 but strengthened during mid-April as European concerns over Spain, Italy and France once again dominated financial headlines. These concerns precipitated the predictable flight to safety in Treasuries. While Treasuries rose off their lows, many bond managers have emphasized Corporates

and Mortgage-backed bonds over Treasuries, preferring their higher yields and equivalent perceived risks. While Treasuries have dropped in yield in April, yields have held stubbornly near March 2012 highs, so Treasuries may prove vulnerable later in 2012 when the US debt ceiling issues return to the headlines.

Bill Gross of PIMCO, referenced above, has also written repeatedly this spring that he is convinced the Fed will be forced to implement new quantitative easing to spur both employment and housing through lower interest rates on long-term bonds. Below is a recent "snapshot" of Pimco's bond holdings, showing its holdings in Mortgage bonds (thick red line) and Government bonds (mostly Treasuries – the thick, light blue line) rising sharply into 2012 in anticipation of the Fed buying both types. Gross and Pimco have generally been good timers of loading up on bonds the Fed would buy during quantitative easing, so we believe that this is a good early indicator of what is to come.



The Managers of Kanos Capital Management

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