Issue 7

PALOS
INVESTMENT FUNDS

February 15, 2013

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Palos Weekly Commentary

■ Palos Income Fund

By Charles Marleau

A Shining Star among the Lifeco's

Industrial Alliance (TSX: IAG), an investment by the Palos Funds, reported a strong fourth quarter which was well above the street estimates and compared favorably to the results of its peers. Some of the strong results came from a one-time securities gain and hedging gains. Even after removing those non-core numbers from the earnings per share (EPS), the result were still spectacular. Here are some of the trends that give us encouragement:

1. Sales growth is healthy.

2. IAG did not have to increase reserves (add additional capital to regulatory capital)

3. IAG is experiencing lower strain (strain occurs because the initial outflows -- such as commission, expenses, reserves, etc. -- occur when a policy is written, and thus have an immediate negative impact on the company's financial position. However, over the life of the contract, future income (premiums, investment income, etc.) is expected to repay this initial outlay and provide a positive return on investment.

4. IAG individual life insurance mortality experience improved (people are dying later).

All of those trends are making IAG a great investment. Palos believes that these positive trends will continue. It makes IAG a compelling investment. IAG was up about 5% on Friday to $38.13.

Chart 1: Palos Domestic Funds*

	FundServ	NAVPS	5D Returns	YTD Returns
Palos Income Fund L.P.	PAL 100	CA $9.14	-0.47%	4.28%
Palos Equity Income Fund - RRSP	PAL 101	CA $7.02	-0.51%	2.96%
Palos Merchant Fund L.P. (Jan 31, 2013)	PAL 500	CA $8.41	---	2.82%
Palos Majestic Commodity Fund L.P. (Feb 14, 2013)	PAL 600	CA $11.20	2.57%	5.52%

Chart 2: Market Data*

	Value	5D Returns	YTD Returns
S&P TSX Total Return Index	36,522.66	-0.85%	2.31%
S&P 500 Total Return Index	2,676.21	0.20%	6.86%
S&P TSX Venture Index	1,185.65	-1.67%	-2.89%
MSCI All Countries World TR Index (CAD)	3,544.05	0.17%	6.44%
US Government 10-Year	2.00%	0.05%	0.24%
Canadian Government 10-Year	2.02%	0.06%	0.22%
Crude Oil Spot	US $95.86	$0.14	$4.04
Gold Spot	US $1,608.80	-$57.20	-$67.00
US Gov't10-Year/Moody BAA Corp. Spread	190 bps	-4 bps	-1 bps
USD/CAD Exchange Rate Spot	US $0.9937	-$0.0043	-$0.0115

* Period ending Feb 15, 2013

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■ Risks, Hedges and Opportunities

By Adam Smalley

ShawCor

The Palos Funds have a long position in ShawCor Ltd (TSX: SCL/A). ShawCor is an energy services company focused on technology-based products and services (primarily pipe coating solutions for infrastructure and E&P companies). In September 2012 the stock traded from around $34 to $42 on speculation that the company would be sold. Shawcor was about to report a record year and there were rumors that the founding family was looking for an exit. We didn't have any particular insight or view into a sale of the company. In early December, the company announced that an acceptable sale transaction was "highly unlikely" and the stock dropped from $46 to $41, providing an attractive entry point in the view of the portfolio managers.

We viewed this as an opportunity to get involved in an undervalued company without having to pay a built-in takeover premium. Moreover, ShawCor is taking steps to collapse its dual share structure (and in the process pay a special dividend of $1 per share). We think the distraction caused by the on-again, off-again M&A process combined with a simpler capital structure allow investors to focus on ShawCor for what it is: a well-run, undervalued company with very attractive growth prospects. Street consensus estimates are for a stock price of $49 in one year, versus a close on Friday around $38.

■ What is New on the Macro Level?

By Hubert Marleau

Should We Be Concerned about Currency Wars?

The simple answer is no. Charges and accusations of currency manipulations have been loud and have flown back and forth between the USA, EMU, JAPAN, BRAZIL and CHINA. That is exactly what it is: noise.

Central banks do not pursue an exchange rate level as a target. The reasons are because 1) there is little in economics that is more misinterpreted than exchange rates and 2) an

exchange rate is a relative price with little intrinsic value. As a matter of fact, the foreign exchange markets are easily misunderstood because they are so complex. It does not take much of a change in exchange rates to influence money, capital and trade flows. The complexity makes it extremely difficult to ascertain realistic values. It is true that countries are more relaxed about currency declines than they were before the 2008 financial crisis. Yet, they know that currency declines are not the way to competitiveness for they can only lead to a "race to the bottom" where there are no winners. There is sufficient proof that an all-out 1930's-style currency war is a useless way to gain an edge in the international markets. There is only one way to achieve competitiveness and that is through lower nominal wages or a "lucky strike" like finding plenty of cheap hydrocarbons.

Additionally, it is mathematical logic, theoretically valid and practically evident that monetary policy cannot affect to its liking interest rates, money supply and exchange rates at the same time. Therefore, central banks focus monetary policy on domestic issues and manipulate the cost and supply of money leaving the exchange rate on its own. It is the job of central banks to restore their economies to normal conditions and not wage acts of war.

Moreover, since President Nixon delinked the dollar from gold in August 1971, countries have allowed market-determined exchange rates to rule, consulted on policies to promote balance growth and cooperated when foreign exchange problems arise. The variables at play in the foreign exchange market are very movable and, in turn, can cause financial instability in the international banking market and create havoc in the world monetary system. It is not in anyone's interest to permit competitive devaluation to take place.

Last Tuesday, the financial leaders of the G-7 promised that the question of currency manipulation will be examined by the G-20 in Moscow next week to avoid a futile round of competitive exchange-rate depreciations. Russia, the host country, wants specific language opposing exchange rate interference.

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It should be noted that the main cause of global imbalance between the USA and China that captivated the world economy has substantially dissipated. In so far as Japan is concerned, it is putting policies together to bring back sanity. Is it not natural for Japan to wish for a bit of inflation after decades of deflation, and a way out of too much debt? The desire for a 2% inflation rate does not constitute an act of war and the world should not fault them for this pursuit. All modern countries more or less have a 2% inflation target. What's the big deal? Japan needs a break.

If you have any questions about the weekly commentary, the securities that we follow, or investment ideas, please contact us at info@palosmanagement.com

Chart 3: Palos International Fund**

	Last	5D Returns	YTD Returns
Palos International Equity Income Fund PLC - CAD	CA $5.19	-0.07%	2.46%
Palos International Equity Income Fund PLC - EUR	EUR 6.75	-0.03%	-0.80%
Palos International Equity Income Fund PLC - USD	US $6.61	-0.50%	1.04%
S&P TSX Composite Total Return Index - CAD	36,803.64	0.36%	3.10%
S&P TSX Composite Total Return Index - USD	36,711.86	-0.17%	2.32%

** Period ending Feb 12, 2013