

February 17, 2012

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■ Portfolio Management

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Palos Weekly Commentary

■ Palos Income Fund

By Charles Marleau, Yarith Chhiv & Adam Smalley

The Palos Income Fund took advantage of the selloff in Keyera Corp., establishing a long position after the company reported lower-than-expected numbers on soft propane prices resulting from the warm winter. Keyera's other businesses, such as Gathering & Processing and NGL Infrastructure, were very strong and the Company is still going forward with its liquids rich gas expansion project. Palos feels that the market overreacted due to abnormal weather and is ignoring significant growth in Keyera's other businesses. Against our long Keyera position, we shorted similar companies that are trading at a much higher multiple, such as Inter Pipeline. This trade – long Keyera versus short Inter Pipeline – makes sense fundamentally and statistically. Inter Pipeline and Keyera traditionally have a very high correlation. However, on Friday, Keyera was trading at a three standard deviation discount to Inter Pipeline.

■ Palos Majestic Commodity Fund

Our trend following strategy allows us to take a neutral stance in the markets, letting us capitalize on bearish movements of commodities such as coffee and cotton, while also allowing us to profit on the bullish trends of crude oil. Cotton fell to their lowest level in 2012 after USDA report forecast higher production and low consumption for the season. Coffee reached a 14 month low, while crude oil rallied behind the risk of potential supply disruptions from Iran.

■ Risks, Hedges and Opportunities

By Adam Smalley

As Greece Burns

After months of comments out of Greece that “we have a deal,” it finally looks like they might have a deal – a watered-down, temporary fix that “kicks the can” but does not resolve the serious issues. There are two things that those involved can say about the bond exchange process: one, that most involved behaved appallingly, and two, that no matter what happens in the next couple weeks, Greece will default (again) in a few years.

Chart 1: Palos Domestic Fund

	FundServ	NAVPS	Weekly Returns	YTD Returns
Palos Income Fund L.P.	PAL 100	CA \$9.47	0.35%	4.14%
Palos Equity Income Fund - RRSP	PAL 101	CA \$7.66	0.32%	3.82%
Palos Merchant Bank L.P. (Dec 30, 2011)	PAL 500	CA \$10.50	---	---
Palos Majestic Commodity Fund L.P. (Feb 16, 2012)	PAL 600	CA \$11.82	-0.03%	0.53%
Palos Rendez-Vous Fund - RRSP	PAL 201	CA \$7.47	0.52%	1.34%

Chart 2: International Fund

	Last	Weekly Returns	YTD Returns
Palos International Equity Income Fund PLC - CAD	CA \$5.61	-0.25%	3.79%
Palos International Equity Income Fund PLC - EUR	EUR 7.32	0.00%	4.25%
Palos International Equity Income Fund PLC - USD	US \$7.07	-0.84%	5.94%
S&P TSX Composite Total Return Index - CAD	34,498.48	-1.22%	4.58%
S&P TSX Composite Total Return Index - USD	34,495.03	-1.72%	6.84%

Period ending Feb 14, 2012

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The negotiations between Germany and Greece are contentious. Merkel has had her foot on Greece’s throat calling for, among other things, Greece to escrow some bailout funds to cover interest payments, a tactic straight out of the high yield playbook usually reserved for the riskiest of the risky and one that undoubtedly rankled Greek politicians. Not to be outdone, Greek rioters burned the German flag, spray-painted “Bank of Berlin” over the façade of the Bank of Greece and managed to bring the economy to a halt. It seems the hedge fund investors were the most professionally behaved actors in this whole thing.

Greece hopes to finalize a deal on Sunday in Brussels with the Euro Working Group. I’m skeptical, but they better get a deal done soon. The March 20th debt maturity of Eur 14.5 billion, unlike all of the milestones so far, cannot be moved.

This week Hank Paulson compared the European situation to the 2008 financial crises in the U.S., saying it would take years to resolve. That is obvious. For investors, we should expect periods of significant volatility in 2012 as the Euro zone emerges from adolescence.

■ **What is New on the Macro Level?**

By Hubert Marleau

Several reputable critics of conventional monetary theory are manifesting suspicion about the supposed beneficial economic effect of the Fed’s ZERO-INTEREST-RATE POLICY (ZIRP) that was introduced in December 2008 and recently extended to late-2014 with a return to normalcy in 2018. A now ten-year project that advocates believe to be necessary and appropriate to suppress and contain the very long expected episode of the debt deflation effect on the prospective level of economic activity. However, a body of experienced bankers and seasoned bond portfolio managers seem to think that Chairman Bernanke is not above it and media is giving them space to make their point. They are arguing in the public press that the standard Keynesian-monetary line that was the appropriate remedy to prevent an economic disaster in 2008 may not be the

one to push the economy forward and upward to full employment. They are calling for the Fed to raise interest rates now. In an oblique, perhaps weird, way it appears to have found its source out of libertarian ideology. Yet, I fail to see any of this in the Austrian school of economic thought where libertarian philosophy is at its best. I stand to be corrected, but my understanding is that the cost of money must ratchet downward to a point of inflection where risky investments can outperform bonds over a very long time. It is only at that moment that investors can be rewarded consistently and over a safe period of time for taking riskier investment decisions. Complaints from the community of bankers and bond managers are much more about the concerning effect that a protracted period of low interest rates can have on banks’ net interest margin and bond portfolios’ profitability. They may be omitting the greater good. An appropriately obliging monetary policy should eventually spur loan and capital demand and ultimately support the economic recovery, job creation and returns for savers.

Incidentally, we may be approaching this point of inflection. During the past twenty years, the risk premium on stocks has been negative with returns on bonds and loans outdoing those on stocks. That is about as long as previous secular cycles of this type have been. It may be too early to predict a turn for the better, but excess bank reserves peaked on July 20 and have since been in a slow-but-steady downward trend; also most of the fall came from increased bank lending and corporate bond purchases. What all this means is that a slow-but-steady improvement in economic activity is becoming visible while missteps and blips could be overcome by continued monetary accommodation.

Chart 3: Market Data

The Markets	Value	5D Returns	YTD Returns
S&P 500 Total Return Index	2,343.67	1.48%	8.60%
S&P TSX Total Return Index	34,796.66	0.61%	4.50%
S&P TSX Venture Index	1,658.15	0.30%	11.70%
MSCI All Countries World TR Index (CAD)	3,107.75	1.70%	8.70%
US Government 10-Year	2.00%	0.02%	0.13%
Canadian Government 10-Year	2.04%	-0.01%	0.10%
Crude Oil Spot	US \$103.24	\$4.57	\$4.41
Gold Spot	US \$1,724.50	\$1.20	\$157.70
US Gov’t10-Year/Moody BAA Corp. Spread	187 bps	3 bps	-3 bps
USD/CAD Exchange Rate Spot	US \$1.0031	\$0.0044	\$0.0242
JPMorgan US High Yield Index*	399.16	0.10%	3.80%

Subject to one-day lag.