



DANCE CONTEST

The market for us is like a perpetual dance contest. You've got to keep moving, adapt to the changing rhythms and make sure you don't get tapped on the shoulder, a loser, forced to retire to the sidelines.

The market has recently been a frenzied dance affair. A veritable conga line. Many got tapped on the shoulder in the face of fast declines. Yet the overall correction which we anticipated in our last few letters, we believe is just that, a correction in an ongoing bull, not the onset of a full-fledged 20% decline type bear market. Even though one would think such a decline is overdue, inasmuch as the US market hasn't had even a 10% correction in over 4 years. Though it just came within a hair of that.

We are wary of being glib or frivolous during the down periods, but it is testament to our belief that this ugly period will pass, that it's a time of opportunity, and that we'll soon be doing the quickstep again.

We may even be close to the end of this recent decline with psychology having gotten very negative and many technical indicators supporting a potential bottom, even if only temporarily, from the capitulation of all those frightened dancers doing the Margin Call Mambo and the Redemptions Rhumba.

The Fox-trot

We value investors are simple folk. We stay with the old-fashioned fox-trot. Two steps forward, a step to the side and one step back. That's what the market is all about—two or more steps forward and one step back. And the economy too. Just like the fox-trot, the economy—but especially the fast growing global economy—has got a forward bias, as countries inexorably grow. Those new emerging dancing fools. And most businesses continue to grow too, despite the odd misstep. In the last several years the market and economy have had more like eight steps forward without a step back. They were clearly vulnerable to a step back.

Value investors don't usually buy the forward steps. Oh, perhaps the GARP ("Growth at a Reasonable Price") guys do. But we dyed-in-the-wool value guys tend to wait for the opportunities presented when stocks take their inevitable step back, or even the little side step, the lateral arabesque, accumulating when things are just moving sideways because we know two forward steps are in the offing.

But we especially like those conga lines when one day they're all kicking up their heels like there's no tomorrow and then someone trips and they all fall. There is a tomorrow. When the subprime mortgage market tanked, predictably, when foreclosures increased, predictably, when house prices declined and the share prices of house builders too, predictably, when mortgage lenders and those funds and financial institutions who buy their packaged loans fell, predictably, when consumer spending weakened as the value of the consumer's principal asset, his house, declined, predictably, when unemployment increased, predictably, and when interest rates for high grade debt moderated, predictably, with the spread between them and lesser quality instruments rising, also predictably, the whole conga line fell, all the participants getting dragged down indiscriminately. But the tougher ones, those with no permanent impairment, dust themselves off and rise to dance another dance, just maybe a little more slowly. They are the partners we seek.

The Panic Polka

We've recently seen many volatile down days where many more stocks have been declining than advancing, the Advance-Dcline Line suggesting we're in a capitulation mode. As is the ratio of puts to calls. According to Hays Advisory, the NYSE oversold indicator is now at the second lowest level since 1940 and the NYSE/NASDAQ 21 day oscillators just gave record low oversold readings. The news is scary and psychology is now unfavourable which is, paradoxically, market favourable. It's "in the market." The best time for us to pick up the tempo occurs when everyone is doing the Worry Waltz, or, better still, like a couple of recent days, the Panic Polka, when markets all over the world declined as much as 3% in the day. Selling what they could, not necessarily what they wished to. The S&P 500 is now flat year-to-date, and down 7% in appreciated Canadian dollars. The TSX is up a mere 1% though up 9% in depreciated US dollars. The real volatility has been in the small caps, with the TSX Venture Exchange down 27% from its May high and down 18% this year. Advisory sentiment has given a contrarian buy signal. Insiders have picked up their buying, and we like dance partners who know the moves. We also like when stocks move from weak hands to stronger ones. A renowned investor of yesteryear, ballroom dance legend Bernard Baruch, claimed he attributed his success to the fact that he liked people. When they were all selling, he helped them out and bought from them. Conversely, when they were all buying, he sold to them. He likely would have been helping out the sellers a bunch these days.

The dancers we intend to avoid for the meantime are the house builders, the mortgage lenders, the stressed financials, the consumer discretionary companies and the other suffering groups struggling to dance with two left feet. Though even in those areas we continue to own some less affected participants such as *CompuCredit*, a subprime lender not of mortgages, but mainly of credit cards, to which we've been adding as all the financials fell. At 5x '08 earnings, with a high return on capital, a solid balance sheet and a management team with an excellent track record, not to mention their 60% ownership stake, we find the shares extremely compelling.

We recently took advantage of the market's verdict of guilt by association and purchased a position in an innovative, growing bank at an extremely compelling price. *BankAtlantic Bancorp* is the parent company of BankAtlantic, a Florida-based bank with 94 "stores" across the state. Given the fact that the company has been investing heavily in new store openings, earnings have been temporarily weighed down. The market's disproportionate focus on short-term earnings vs. the long-term earnings potential or underlying asset value often punishes companies that invest in expanding their operations. This tendency to miss "the forest for the trees", along with a general mistrust of all things financial (particularly all things financial in Florida), provided us with what we believe to be a great opportunity. The market had clearly thrown this stock out due to its aforementioned industry and locale without much thought as to the true risks to the business. It was trading well below book value, a price rarely seen on banks in the absence of significant risks to their ongoing viability. Our work determined that BankAtlantic was still a growing franchise based on strong new store growth and the positive demographic trends in the state (which will not be reversed by concerns over condo prices). More importantly, we found that BankAtlantic's loans were much lower risk than your average bank, having exited some of the more troubled areas of the Florida real estate market two years ago. Their earnings have been temporarily depressed by aggressive new store opening costs which are investments in future growth, not any indication that the company is writing bad loans. In short, we were able to buy a bank that is growing faster than its peers, with a lower risk portfolio of loans at a severely discounted price.

Our team of portfolio managers had an addition this quarter, and so did he (his first child). Clearly dirty dancing. Anthony Hammill, a specialist in US stocks, has an innate value bias, which we intend to exploit. BankAtlantic was Anthony's brainchild and his chair's not even worked in yet.

Even though we want to avoid the obvious problem areas, that's not to say we won't be patiently monitoring all the troubled groups for when we think their share prices have fully discounted the problems. If you wait for the right moment, you just might jump into a Housebuilders' Hora.

Then we own some companies that should be oblivious to the groups under stress. They dance to their own tunes.

Like *Allen-Vanguard*, whose defense business should grow even in a slow economy. We recently added again to our positions by participating in a private placement at \$6.85 to fund the acquisition of its largest competitor from a private equity firm that was winding down. We also assisted in a conditional bridge financing where our clients (with margin accounts or excess cash) earn a 5% commitment amount, even if we don't have to put up the funds, and an additional 2% fee and a 10% coupon as well if we do have to advance the funds. The company has announced an equity issue which they'd like to close prior to September 30, obviating the need for our bridge funding.

Our enthusiasm for Allen-Vanguard stems from the attractiveness of the business and its prospects, which include: counterterrorism products which are in high demand; a large market opportunity with significant government budget allocations to bomb jammers; a highly strategic and synergistic combination with its nearest competitor in stature and geography as both are Ottawa-based companies; high returns on capital and next to nothing ongoing capital requirements; a significant barrier to entry for competition due to leading technology and significant partnering relationships with Lockheed Martin and General Dynamics; a compelling valuation as the company trades for around 10x earnings. In fact, the only two brokerage analysts who cover the stock both raised their one-year targets from the \$10-\$11 range to \$19-\$20 based on what we believe to be conservative assumptions.

Our Jeremy Rakusin is to be recognized for introducing this idea and conducting ongoing due diligence in a complex transaction enabling *Allen-Vanguard* to become one of our largest and most prospective holdings in short order. Talk about slick dance moves.

Another company we recently purchased that should not be affected too much by the general economy, notwithstanding that it's a miner, is *Formation Capital Corp.*, a Canadian company with high purity super alloy grade cobalt assets in Idaho. It owns 100% of The Idaho Cobalt Project, the largest and highest grade primary cobalt deposit in the world. Its estimated production costs are in the lower quartile with mine construction commencing at the end of '07 and production startup in Q1 '09. The company has never missed on a drill hole and the mine is open along strike and at depth. Formation's NAV is over \$2.00 per share (assuming \$21 cobalt prices and \$1.50 copper prices, both well below prevailing prices). Because it has no lead, the high purity cobalt that Formation will produce is vital to medical applications (e.g., prosthetics) and aerospace (to meet stringent specs, unlike, say, African cobalt which contains too much lead for high purity applications). And, there's blue sky potential from higher cobalt prices (already 30% higher than the \$21 pricing used in our NAV) and from finding additional reserves.

The company has fully funded the substantial equity portion of its mine development plan. Mine permitting is essentially complete with no material risks remaining. There is no other domestic US supply of high purity cobalt at the moment, yet the US is the largest user of high purity specialty cobalt so marketing should be a cinch.

We sold a couple of positions in the last quarter, including *Pinnacle Airlines* which reached our sell target and *United Health Group* which inflected off a "ceiling" and gave a sell signal in our work. We're looking to repurchase United Health Group as it has now fallen to a "floor."

High Energy

We continue to emphasize energy and golds. We are a little concerned with the recent pullback in the price of oil to a still healthy \$71 per bbl worrying that it might weaken somewhat more seasonally before it charges on to new highs. But we think natural gas is bottoming and its price should rise dramatically, as should oil, over the next few years. We think oil prices will inevitably go over \$100 per bbl. And we think North American natural gas prices could go to \$14-\$15 an mcf. Those gas prices will benefit all of our coal bed methane producer stocks. They will also benefit *Canadian Superior* which produces gas in Western Canada but is currently drilling a monster gas prospect offshore Trinidad. And, our biggest holding, *Corridor Resources*, should really benefit.

Best of all, regardless of the commodity price, our oil and gas producers continue to add value by growing their reserves with the drill bit.

While *Orca Exploration Group Inc.* has its holdings in the Songo Songo gas field offshore Tanzania and is limited in much of its gas pricing by government regulation, it should grow its production significantly, from 18 mmcfd to 60 mmcfd by '09. Exploration success could double its gas reserves, and with its large reserve base and minimal declines it should generate significant cash flow for many years. Orca recently raised \$30 million and is currently evaluating several plays in Sub Saharan Africa including Gabon.

We remain very excited about the prospects for Corridor Resources, a New Brunswick natural gas producer, which has drilled 25 consecutive natural gas wells in its McCully field with no dry holes and now produces 25 mcf per day through its just completed pipeline which connects to the Maritimes & Northeast Pipeline. Production is expected to grow to 45 mcf per day by year end. At half of the pipeline capacity, there's plenty of room for growth. The McCully field has the potential for several hundred wells and perhaps 1 TCF of gas (approximately 75% net to CDH). The reserves are long-lived at 25 years based on initial pipeline capacity. Cash flow is anticipated to be over \$2 per share within 2 years.

In the meantime, the company has also drilled into the thick, lower zone, Frederick Brook formation which was found to be gas bearing with significant natural fracturing. Testing of this zone is commencing soon and the results could be known in several weeks. If it's judged commercial, it could have a great impact. Then too, yet an even deeper zone, the Dawson Settlement, will be drilled and if gas charged could contain as much as 5 TCF.

The total company has "unrisked" upside to over \$100 per share and a "risky" net asset value of about \$18 today, which could be achieved shortly, and then some, by Frederick Brook testing and drilling. The company trades at a reasonable 6x '08 cash flow. And, an \$18 share price would be justified in 2-3 years based on a 6x cash flow multiple with only McCully production and \$8 per mcf gas prices.

Petrolifera's share price has suffered lately resulting from it losing some production momentum and having to reduce its guidance for the year's total production. A number of temporary issues have conspired to delay better results: the company suffered from difficulty accessing drilling rigs, the need for a water flood with reservoir pressure declining, waiting to install pumps as the company does not want to put a pump on any well while it is free-flowing, delays in facilities, rig delays and transitioning logistics from the transfer to direct operatorship.

Petrolifera is currently producing over 8,000 bpd of oil and gas equivalent from Argentina. They have over 1 million acres in the country plus 1.2 million acres in Colombia and 5 million in Peru. At the current stock price, Petrolifera trades for 6x '08 EPS and 4x cash flow. With production growth of nearly 100%, '07 over '06, and the same growth expected in '08 over '07, we believe the stock trades cheaply. The company has not drilled a dry hole and most wells are free-flowing to surface.

Over 50 locations should be drilled in the remainder of '07 with year-end production estimated at 17,000 bpd. The company has a massive land package for exploration. Peru, in particular, includes a prospect of 10 TCF of gas and 500 million bpd of liquids plus a number of 50-150 million bpd prospects. The company is debt free and its cash on hand plus anticipated cash flow should be adequate for its aggressive capex program. A conservative risked NAV is just under \$20 and is rising rapidly with drilling results proving up incremental reserves.

Pacific Energy announced in May a major acquisition of offshore Alaska, Cook Inlet, assets from Forest Oil which considerably boosts the company's reserves and prospects and provides diversification. This asset complements the company's offshore Long Beach, California assets. Combined production should exceed 8,000 bpd in '08 and development opportunities could more than double that over the following two years. The company is trading cheaply on expected earnings and cash flow. With over \$1 in cash flow per share expected in a couple of years, the stock should trade at twice its current share price. The Pacific Creek, Wyoming exploration play could add even more value. This 99,000 acre area, with geology analogous to the well known Jonah field just 20 miles to the north containing about 10.5 TCF of gas on just 30,000 acres, makes this exploration play very exciting. Results are expected from the company's first well there in just a few weeks.

We are about to dispose of one of our energy positions in a takeover as *Rally Energy* announced it will be acquired for \$7.30 per share in September. While we did expect a higher ultimate target, the takeover price does represent current NAV. Should the company be successful in its drilling in Pakistan later this month, considerable net asset value could be added which might still attract a higher bid. In the meantime, believe it or not, given the market's inefficiency last week, you could still buy Rally at a discount to the takeover price yielding an annualized return to the closing deal price of over 20%, not to mention the incremental potential from a higher bid.

Shorts Spin

Because we believed this anticipated correction would only be a bull market correction, we were only about 10% short, therefore also unfavourably impacted on most down days. When the cops raid the dance hall, they take the nice girls too. We still think the market is over 30% undervalued relative to the benchmark 7 year US treasury yield of 4.4%, and at only 14x S&P 500 forward earnings. Many beaten up US financial stocks now sport 5% dividend yields. So we stay fully invested in undervalued good companies and short overvalued and bad companies. Unlike those wallflowers who rush to the exits to cash, "risk free" US T-bills, standing on the sidelines ogling all the attractive dancers tripping the light fantastic. Looking at all those great bottoms but not able to act. Clearly fear of rejection. Short selling is more efficient to deploy defensively than merely going to cash. Additional protection, allowing us to more comfortably maintain or even add to our favourite holdings notwithstanding, or because of, their temporary price weakness.

New short positions include *SNC Lavalin*, *Corn Products* and one which we've already covered, *Sonus*, after it announced disappointing results and the share price dropped. We eliminated our *Wendy's* short, and based on private equity takeover rumours in May, with takeovers occurring on virtually a daily basis, we removed the *Dillard's* short. Naturally, it subsequently declined substantially, to our regret. We see little value in being right but not benefiting, though it does give us confidence that we're on the right track.

Liquidity Lift

Those cash laden wallflowers, for whom redemption has nothing to do with seeking an afterlife but merely to turn investments to cash and live to play another day in this life, create the very liquidity necessary to start the music again. And the Fed, having previously removed the liquidity punch bowl as it raised the Fed funds rate in successive steps from 1% to 5.25%, all concerned about inflation and overheated markets, is now without doubt just starting to bring that punchbowl back to the party and get everyone happy again. Friday past, it lowered the discount rate by 0.5%. The Fed funds rate is sure to follow. Best of all, the 3 months US treasury bill auction today yielded 2.94% compared to 4.66% just one week ago. All those wallflowers, but hey, yum, cheap money and more liquidity. Rumour has it that M3, a now unpublished statistic of broad money supply in the US, is growing at 13% annually and at over 10% throughout the industrialized world. Central Banks around the world just injected in a few days the equivalent of US\$400 billion into the monetary system, US\$214 billion from the ECB alone. A serious liquidity fray. Actually a "Freilich".

All that money has to go somewhere. As we have written many times, when US 10 year treasuries only yield 4.61%, a meager return, especially after taxes, and when the prices of other asset classes, including real estate and commodities generally, may be extended, equities, by comparison or even by default, are the most attractive asset class. This is especially so when the S&P 500 earnings yield at 7.34% is far superior to potential interest income and when capital gains on stocks are treated much more favourably than the full tax on interest income.

We don't just dance with anyone, indiscriminately. We're picky about our dance partners. This has been a time when the market for stocks is more important than the stock market. We want to buy pieces of businesses that will be impervious to, or even prosper despite, the slowdown, or have discounted its effects—at bargain prices. Returning the punchbowl will beget a new dance party. The slowdown will beget increased growth. The market correction will beget a recovery. They always do. It's the fox-trot. Two steps forward, step to the side, one step back. Most importantly, on the big dip last Thursday the financials hit and bounced from a significant "floor" in our work down 40% from their highs earlier in the year. The S&P 500 and TSX have reverted to floors and remain "on buy." We're anticipating the next steps to be forward.

Credit Crunch

When lenders and borrowers were dancing cheek to cheek, oblivious to the risk of defaults, protected by securitizing CDOs ("Collateralized Debt Obligations", or, as we know them, "Crappy Debt Offerings") and by derivatives, all overrated by the rating agencies, eyes closed in hedge fund delirium, squeezing so hard it morphed into a crunch, the Credit Crunch. The music just stopped. Defaults everywhere. Subprime lenders going broke. No liquidity. No bids. No way to value holdings. Big and reputable French bank BNP Paribas suspending three funds. Big and reputable investment bank Bear Stearns allowing the collapse of two of its hedge funds with big subprime bets. Big and reputable Goldman Sachs smarting from concerns over its Global Alpha internal hedge fund.

The dance hall can withstand the anguish of these smoothies, but what is really going to hurt the economy is the impact on home ownership from the mortgage crisis. Mortgage rates rising and mortgages more difficult to obtain. Stricter lending standards. Not just for subprime but creditworthy borrowers too. A big rate bump for jumbos. Much of the adjustment for ARMs still to take place. A rise in delinquencies and home foreclosures. Declining housing starts and sales. Declining real estate prices. It was inevitable. A fan dance. When the "s" hits the fan.

Retailers will hurt as homeowners have less wherewithal and appetite for consumption.

Fannie Mae and Freddie Mac, pressured by Congress, may end up helping somewhat. Politicians and central banks respond to crises. But the Subprime Samba will have to run its course.

Paradoxically, even as homeowners and consumers suffer, corporations still have good balance sheets with which to help per share earnings through buybacks or to acquire competitors. Share buybacks, takeovers and huge LBOs. Chrysler, Alcan, BCE, ABN AMRO, Western Oil Sands. The Buyback Boogie. Shrinking the supply of shares even as new supply from IPOs is waning. As liquidity increases and the available pool of shares and their respective values diminish, look for share prices to stop declining. Simple supply and demand.

Stagflation Stomp

Paradoxically too, even as US house prices decline and the US consumer retrenches, general inflation could pick up. Global demand for stuff continues to rise. Food prices and energy. Wages are rising too. As central banks increase liquidity, money cheapens. Cheap money begets demand for finite stuff.

Inflation is picking up in the developing countries, up 5.6% in July for China and, for India, over 6%. Interest rates in Australia are up to 6.5% and over 8% in New Zealand. Canada is itching to raise theirs notwithstanding the strong loonie. But, current Fed funds futures suggest an 80% chance of a cut in the Fed funds rate in September. And lower again in December. Whenever the Fed starts to cut it normally continues for at least 3 more cuts. A slower US economy and lower rates compared to those of trading partners could cause a further dollar decline. Rising oil prices contribute to a slower economy as the consumer spends more on gas and has less to spend on other stuff, but is also inflationary. Not a dollar friendly circumstance. The current US dollar rally is just about done. It was encouraged by a temporarily oversold dollar, a flight to the safety of US T-bills and the unwinding of the Japanese Yen carry trade which caused other currencies to decline more than the US unit. China threatens to stop buying US bonds if Congress doesn't stop threatening protectionist legislation. A weaker dollar will exacerbate US inflation. Higher import prices. A central banker's worst dance nightmare. A slower economy and rising inflation. The Stagflation Stomp.

Golden Goodies

Plentiful and cheapening money, the prospect of a lower dollar and of foreign central banks and others who want to diversify away from it, and generally rising prices make for a very favourable backdrop for a higher gold price. A safe haven currency during a flight from risk too.

On top of which the gold business is lousy. Rising costs, shortage of miners and professionals, a difficult commodity to find, with prices suppressed by European Central Bank selling. Newmont is struggling, with a \$2 billion hedgebook hit to boot, the South Africans are in a labour struggle with unions seeking a "mere" 16% wage increase. Harmony loses its CEO and Goldfields is having a tough time too. Barrick stuck with its massive hedges. Lower earnings from higher costs for Goldcorp. Poor guidance from Kinross. In all, a prescription for a higher gold price, despite the metal's current abysmal action because everything is being sold plus also likely, a reaction to temporary dollar strength. Look for much higher bullion prices. Then a rush to own the sector whose total market cap is less than that of Microsoft.

As in the case of our oil and gas stocks, we anticipate our golds will grow by adding resources with the drill bit. We avoid the big golds because we are perplexed as to how Barrick can replace 8 million ounces of annual gold production and Newmont 5 million. With resource stocks, less is often more.

High River Gold Mines should be producing at the rate of 350,000 ounces of gold in '08, almost triple the production rate of the last year. With good growth ahead, low production costs and the change in the company's status to a mid-tier producer, we believe the share price should trade closer to the 10-12x cash flow multiple of those peers rather than its current multiple of 5.5x '08 cash flow.

Etruscan Resources continues to report exploration results which show the excellent breadth of its properties in West Africa. Meanwhile, the existing portfolio of development projects alone should justify a substantially higher stock price.

St Andrew Goldfields continues to report losses mostly from the expensing of its exploration and development costs as it develops its Holloway-Holt operations for production, but in the meantime has recruited an outstanding new President and CEO with significant operating experience. We anticipate that once a production decision is made, later this year, the company should become cash flow positive. Not to mention the prospect of growing its resources from its significant exploration program.

Two new additions to the golds in our portfolios include *NovaGold Resources* and *Firstgold Corp.* NovaGold's gold and copper assets are primarily in Alaska. The company has a resource of over 44 million ounces of gold and 16 million pounds of copper. It trades one-third below its NAV and the company's production profile should catapult it from a development company through junior producer to mid-tier producer over the next few years, throwing off over \$1 billion in annual cash flow in 5 years.

Firstgold is a Nevada-based gold producer whose first mine is just starting production. We expect 100,000 ounces of production from the company in '08 and a doubling over the following two years. With reasonably low costs of \$225 per ounce, we expect earnings to be robust. And, the company has significant exploration opportunities as well.

Income Accounts

Activity in the income accounts was low last quarter. We sold our position in Altus Group and added a position in 8% Uniserve Convertible Preferred Shares. *Uniserve Communications* delivers hardware and proprietary software solutions to smaller cable companies enabling those companies to provide voice, data and broadband services to its customers.

Dancing With The Stars

The current dance is one where the big cap dancers which are not in the directly affected groups, the stars, will be more attractive than the smaller caps. Mostly because they also address the global economies which are stronger than the US. On the other hand, as male dancers who prefer to lead, we know we can usually lead the smaller caps whom we know intimately and to whose managements we can have input. Those less accessible big cap stars prefer to lead, often stepping on our toes with no qualms. But if they lead us where we want to go we're happy to dance with them too. We're equal opportunity, multi-cap dancers.

The market for us is, indeed, like a dance contest. Not musical chairs, because the music never stops, just the melody changes. We always want to be in step with the music, whatever the tempo. Indeed, as value investors, to anticipate the changing tempo, exploiting the one step back even while the exhausted others are stumbling through the Meltdown Merengue. If gold rages, we want to be there. As natural gas takes off, we want to participate. Whenever oil hits \$100, we'll be doing a dosido. In the end, we want to win. Not just for our clients, but to prove to our skeptical significant others that we actually can dance.

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