



HIGHER PERSPECTIVES

The title to this letter is the slogan we've been using in recent advertising with our new name. It implies, somewhat pretentiously, that from our lofty perch at Trapeze, we have a great view to see what is "really" happening in the investment world and an ability to discern reality from perception. Right up there with a triple somersault.

Recent perceptions have been that we're in a speculative commodity blow off. Most industrial metals recently made new highs. The CRB Index up 12% in April. Indicative of a strong worldwide economy. Good for commodity stocks and for markets generally. Then the perception, as commodities and commodity stocks recently corrected, that the cycle was over, indicative of a potential oncoming slowdown. Higher commodity prices suggested more inflation and therefore necessarily higher interest rates which would snuff out expansion. Stock markets everywhere, especially those in Asia and Latin America, have been correcting.

In just nine trading days ending May 23, the DJIA dropped more than 540 points or 4.7%. The Indian market dropped a whopping 20% in just days. A staggering \$300 billion off the value of emerging market equities in 10 trading days. Our own TSX Venture Exchange, from peak to trough, dropped 19.5% in 6 days. Some are even suggesting the conditions are similar to those that preceded the '87 crash, high equity prices, rising interest rates and a declining dollar. Ugh.

All that money trapped in energy and other commodity stocks that might be inclined to seek safer ground. All those hedge funds that could blow up. The end of the Japanese carry trade as Japan starts to raise rates and its potential deleterious impact on hedge funds, interest rates, stocks and commodities.

April PPI was up 0.9%; ex food and energy 0.1%. April CPI was up 0.6%; ex food and energy 0.3%. Higher inflation, higher interest rates? Some say we're on our way to hyperinflation. Though others, such as Elliott Wave, Kondratieff theory adherent, Robert Prechter, still believe we're on the verge of a deflationary depression. Nice choice.

Wall of Worry – Perceptions

From our perch we can see the wall of worry getting higher. Housing is clearly slowing. Therefore the consumer's principal asset is at risk. Oil prices are high and may go higher crimping consumer demand. The US dollar has been declining and could go lower and US

policy may be acquiescing in it. The US trade and current account deficits remain stubbornly high and result in too many dollars held by foreigners, maybe to an unwanted degree. The budget deficit remains high, with personal tax receipts below those of the Clinton years and with spending increasing, \$10 billion a month required for Iraq alone. An outsized amount of derivatives outstanding, multiples of the US economy and unregulated too. A growing nuclear threat from Iran and daily preparations to thwart it. An obstreperous China and Russia. An unpopular Iraq war. An unpopular immigration policy. An unpopular President Bush, with ratings at an abysmally low 29%. An increasingly unpopular Republican party—the party of business and therefore the party of the stock market. Volatile markets, rising interest rates, a scary housing market, unpopular leaders. What’s an ordinary investor to do? Head for the exits? The proverbial “Sell in May and go away.” Or the one we hear from some nervous clients, “Go to cash before the Crash.”

Reality Check

As value investors we love walls of worry, the higher the better. If it’s “in the market”, i.e., the concern already discounted by investors, then the actual event is less likely to have material impact. But, what it has done is create opportunity to find bargains. And, we are indeed finding the names, many big cap names, and agonizing over what we can sell to have the funds to add them. A good problem.

Reality is, interest rates, though rising, are still historically low. Worldwide. Favourable for equities. Before the '87 crash, 10 year treasuries yielded over 9%, but the earnings yield on the S&P 500 was less than 7%. Today, the S&P 500 earnings yield is 7%, but 10 year treasuries yield a mere 5%.

Reality is, though house sales are slowing, inventories are high and house prices may decline somewhat, the Fed is watching it closely, well aware that \$2 trillion of adjustable rate mortgages will be fixed at higher rates over the next couple of years. If the Fed is at or close to “neutral” rates, rest assured they will react in the face of a slowdown, now that they have some maneuvering room. The cavalry (read, the Fed’s punchbowl) to the rescue. Reality too is, though the non farm payrolls for May disappointed, unemployment is generally low and labour in many areas, like other commodities, is scarce notwithstanding all the layoffs and the job losses to China that Lou Dobbs rails about nightly. Reality is, high oil and gasoline prices don’t seem to have crimped consumer spending excessively. Consumer spending grew in April at the fastest pace in 3 months. Wal-Mart apart, many retailers are reporting healthy same store sales growth. Consumer sentiment slipped in May from a 4 year high in April, but was still above economists’ expectations. Now, if the consumer becomes less profligate, it’s understandable, as he’s now required by law to make higher payments on his credit card debt and is generally feeling less wealthy, with apprehension about housing, oil prices and the volatile stock market. But, saving a little more and spending a little less may not be a bad thing for a nation that has had such a poor savings rate. And, savings are the ammo for financial assets.

Reality is, housing is slowing, and it may be a buyer’s market for some time. But it also may be a buyer’s market, believe it or not, for housing stocks that look cheap at about 6x expected earnings that have already been revised down. Home Depot looks very cheap and we want to buy it. The stocks of these wonderful companies may have, to a great extent, discounted the housing correction. That’s what public markets do. Create the opportunity.

Reality is, US automakers continue to narrow the productivity gap between them and Japanese manufacturers. GM's share price is up 40% from its lows this year and being recommended as a buy, despite the layoffs (or because of them), and despite its loss of market share to Toyota and the like. As GM goes so goes America. Sayonara Lou Dobbs.

Win Win

Reality is, there could, indeed, be an economic slowdown. Worldwide. Rising interest rates, a housing decline, rising oil and commodity prices, could all work to slow the US economy. An even lower US dollar could result. Not so bad for US companies for whom overseas earnings now comprise 26% of profits. Because much of the world is dependent on US imports, they would slow down too, with foreign exporters particularly hurt by their rising local currencies. But a slowdown, though bad for earnings of many companies, will likely result in lower interest rates and rising liquidity—good for financial assets, best for equities compared to bonds because of the risk of stagflation. The money has to go somewhere, and if it isn't into real estate or fixed income which are less attractive, it will, by default, go into stocks.

On the other hand, if there is no material slowdown then earnings growth can be sustained and equities will be the go-to asset class in any event. A win win. The fact is global interest rates would have to go considerably higher to materially impede stock prices. The fact is money supply growth in the US at 4.9% is tame compared to that of Europe (6.3%), and China (a whopping 19%), and Japan where, for years, liquidity has been outsized to combat deflation and is just starting to be reined in.

Reality is, as the US dollar declines, other countries have to get more productive. Good for the global economy, worldwide inflation and interest rates, and for stock markets.

Interestingly, big cap companies, a group that has underperformed, are looking more attractive. Berkshire Hathaway recently bought millions of shares of GE and Conoco, and even some Home Depot, and they've been pretty cautious. Corporate balance sheets are very strong and though dividend growth has been anemic, corporations have been buying back shares which they think are cheap. Insiders have been stepping up their purchases too. Corporations have also been buying up the shares of competitors and other similar businesses, often in an unfriendly way. Teck is bidding for Inco. Xstrata for the 80% balance of Falconbridge it doesn't already own. Mittal for European steel giant, Arcelor, which in turn, fends it off with a proposed merger with Russia's Severstal, with a view to creating the world's largest steel maker. More to come. Less competition. Better pricing. Reduced unit costs. Good uses of cash. Better returns on invested capital. Higher earnings per share. Higher share prices. Our kind of reality.

Reality is that the technical indicators for the market are healthy and improving: the ARMS Index (shows the energy it takes to push the market lower—favourable); the Rydex (measures the emotional mutual fund investor, more turning bearish—favourable); the Total Put/Call Ratio (measures the emotional options trader—the most pessimistic since 1995); Odd Lot Short Sales (spiked up—the small investor is usually wrong); AAI bearish sentiment (the highest since the bottom of the market in Oct. '05); insider buying (the highest since April '05); the Short Interest Ratio (rising smartly—increased bearishness); US dollar sentiment (most bearish it's been in over 20 years—the market could rally with the dollar).

And there's lots of money on the sidelines. Retirement savings in the US alone rose to \$14.3 trillion in 2005.

Our SVA™ work shows that the big cap-weighted indexes have all given buy signals and simply retreated back to “floors” on the recent market correction.

But, the ultimate reality for us is that, at current interest rates and based on anticipated S&P 500 forward earnings, the market is currently 23% undervalued. Corporate profit margins are the highest in over 50 years at 8.3% of GDP and the S&P is trading at only about 14x '07 anticipated earnings. You earn it and they will come. Value will out. Small caps, though, representing the broader market, now trade at an excessive premium to the large caps which we think will ultimately shrink as the big caps outperform.

Market for Stocks

Value investors like to say that there is a stock market and a market for stocks. By that we mean that even if the market as a whole may be languishing, certain groups and individual names may nonetheless be attractive. Too much time can be devoted to the macro—the economy and overall markets—and not enough to bottom-up stock picking. But one macro notion that we do embrace is that we think we are in a supercycle, where finite commodities—oil, gas, uranium, copper, nickel, lead, zinc, gold and silver—will be in short supply, partly because for 20 years of bear markets they were underexplored and now mostly because the developing world—China, India, Latin America and now, even Japan, as it comes out of the doldrums—will continue to have an enormous and growing appetite for them. We're superbullish on North American gas stocks as the excess storage ultimately gets worked off and the hurricane season is upon us again.

Back to bottom-up, we think our individual holdings are cheap. And we continue to overweight oil and gas stocks. With all of the hype about rising energy prices, you'd think our oil and gas holdings would be sporting full valuations. But the market has been unwilling to apply these high energy prices, believing that they won't last. However, even if the price of oil were to retreat to the high \$50s, the stocks we own would still be extremely cheap. Assuming \$60 oil, *Pan-Ocean* trades at 4x next year's expected earnings, less than half of the multiple of its peers. *Pan-Ocean's* prospects remain exciting with low risk development drilling and plenty of exploration upside. With the oil they have already discovered, at \$60 oil, the company is on track to accumulate over \$1 billion in free cash flow over the next 5 years. That's more than the current share price. And, even in the face of these difficult markets, *Pan-Ocean* just touched a record \$44 and appears to be breaking out, on its way to its next “ceiling” at \$52.

Petrolifera also trades for only 4x earnings, remarkable given the company's major success in Argentina and its prospective 5 million acre land position in Peru. The company trades at half of our estimated fair market value which we think will grow materially.

We continue to hold a high proportion of oil and gas stocks because they can provide a triple whammy. With most of our stock selections, we only look for a double whammy—a lift in the stock price, as the undervaluation gap is narrowed by the marketplace, plus the expected growth of the company's business. In the case of energy stocks, we have a potential added bonus of high and rising energy prices. For example, with oil at 10% above today's prevailing price, *Pan-Ocean's* next 5 years of accumulated free cash jumps to \$2 billion, double our current expectation. We are not counting on that, but, neither are we paying for it. On the other hand,

for our energy stocks to outperform, over time, we only need the oil price to remain in the upper \$40s. No doubt, we'd also be temporarily impacted if the whole sector declined because the oil price fell that low, but we believe the companies we own would soon recover. They are too cheap and growing too quickly to stay down for any extended period.

Connacher, with excellent oil sands properties, will start to extract bitumen using conventional horizontal drilling at the end of '06. We expect substantial reserves to follow, yet the stock trades at a discount to its current net asset value.

Corridor has moved up in price and no longer trades at a low prospective earnings multiple. However, the company trades in line with its net asset value after its 16th successful gas well. There is much more drilling to come and this fall we could begin to see the potential from the much deeper Dawson Settlement zone, which could potentially contain a staggering 5 TCF of gas. The company also has potential from land in PEI, offshore Cape Breton and offshore Quebec.

Canoro trades at one quarter of its net asset value. *Canadian Superior* at half and *Rally* at almost half. We expect growing net asset values, cash flows and earnings from these and the other oil and gas companies we hold.

Our golds are cheap too and growing, and gold should ultimately do well in any kind of economic outcome even, perhaps, where other industrial commodities slide. Financial insurance.

And, we can also make the same argument in the case of our gold holdings as for our oils, that is, that they trade below net asset value or at cheap multiples of earnings even based on a gold price lower than the current price. With prospects for upside from exploration and development to boot. *Yamana*, *High River*, *Etruscan* and *St Andrews* are all cheap and potential triple whammies, too, if the gold price stays high or rises.

In the mere double whammy department, *Sprint Nextel*, *UnitedHealth Group*, *TJX Companies*., *Pacific Sunwear* and others trade well below their fair market values even though the companies keep delivering steady growth of their intrinsic values. These stocks are being shunned by the market for various reasons, temporary or unfounded. Once the clouds lift so should the prices. Value manager, David Dreman, said this about value investing in his recent Forbes column: "High-flying stocks get slammed by negative surprises and are helped only a little by positive surprises. Value stocks, though, get boosts from positive surprises, but aren't much hurt by negative news. Disappointment is already priced into the shares."

The short positions have protected us somewhat in the recent decline. We've booked gains in *Novatel*, *Sirius*, *KFX*, *National Semi* and *Ultratech*. Because we believed the recent downturn was merely a correction in an ongoing bull market, we have not put on an overly large short position.

After a sideways performance from our overall income positions, we have had some lift recently. *Specialty Foods* and *Entertainment One* have been the main culprits with a couple of other underperforming income trusts to offset our winning positions. Specialty Foods has just been refinanced in a financing led by us which closes in early June. We've suffered a big loss in our existing position, but believe the newly capitalized company, which has remained profitable in the face of adverse conditions, should be a very successful investment allowing us

to more than recoup the loss. Those who held the trust units will be purchasing 8% Secured Exchangeable Notes which, in addition to the fixed interest income, will also be entitled to any unit payouts and also stand to enjoy material capital gains as the company improves. Commodity prices—chicken, beef and pork—have all fallen dramatically in recent months allowing Specialty Food’s packaged meat margins to swell.

Entertainment One trades at an unjustifiably low price. A 26% yield based on the current payout of \$.90 per unit, down from last year’s \$1.30 (after poor results from the dismal movie release schedule of 2005). But, business at EOF is good. Maybe their lenders need to cooperate a little more; however, this should not be insurmountable given the solid franchise and profitability. Meanwhile, management keeps signing exclusive distribution arrangements and strengthening the company. The President, himself, recently bought \$1 million worth of units.

Balanced Strategies

We always take more account of risk than reward. To do otherwise would be speculating, not investing. Accordingly, we have endeavoured to avoid country risk at a time when it is increasing. Confiscatory policies in many countries such as Bolivia, Venezuela, Ecuador, and Mongolia are making foreign resource investments riskier. We do have exposure to: Gabon (Pan-Ocean); Romania (Sterling); Trinidad (Canadian Superior); Peru and Argentina (Petro-lifera); Burkina Faso and Russia (High River Gold); Tanzania (East Coast Energy); India (Canoro); Niger, Burkina Faso and Mali (Etruscan); Egypt and Pakistan (Rally). All places where we believe the political risk is acceptable. Mind you, Hillary Clinton is calling for a windfall profits tax on big oil in the US. Go figure.

Despite the name Trapeze, we try to be sensible, not daring. To buy when others are selling and when the wall of worry is obviously high. One of the greatest attributes investors should have is a healthy degree of skepticism. We know that managements mostly say bullish things. That analysts put out far more buy recommendations than sells. That government statistics are unreliable, often untrue. That politicians mostly care about keeping their jobs. Just like us. That the Fed cares about inflation and jobs, but mostly about jobs. Absent extremes, no matter inflation, no matter the dollar, if job losses mount, interest rates won’t go higher, indeed may go lower. And, we know that free markets work and allow for constant adjustments to changing realities.

We have good people at our shop. Disciplined and skeptical. We read as much as we can. We analyze as well as we can. And, we use the best analytical advice we can find from other firms. We believe “value will out” and so we’re always trying to find “real” bargains, not “value traps”. Good and growing businesses temporarily trading below their true intrinsic values, for whatever temporary cause. Reducing risk where we can. Trapeze artists always look down first.

Most of all, we try to use common sense, which in the end is better than all the analytical smarts the Nobel Laureates at Long Term Capital apparently had.

Many of the apparent worries are discounted and many could dissipate. Bush’s popularity can’t get worse. It may lead him to undertake a quick and successful adventure in Iran which could have beneficial consequences for operations in Iraq too which suffers from Iranian mischief.

Watch his popularity rise over the next 1½ years and help the Republicans as the US withdraws and an effective Iraqi military takes over.

What if Osama is finally captured? What if Hamas acknowledges Israel and that the earth is round? Or Michael Jackson is liberated from Bahrain?

What if the trade deficit starts to shrink as imports diminish and exports increase, a result of a slower economy and lower dollar? Better still for GM. Hey, as a result of its rising loonie, Canada's travel deficit with the US hit a 12 year high, Canadian manufacturers have been scrambling to cut costs and its manufacturers, like Bombardier, may have to move jobs to the US. One man's loonie is another man's gain.

What if new Treasury Secretary, Henry Paulson, a proponent of tax cuts and spending cuts to effect a lower budget deficit, and of an orderly decline in the dollar to naturally adjust the trade deficit, is just the tonic for the economy and a resumption of the bull market?

What if personal incomes finally start to rise from improvements in average hourly earnings? What if the Fed stops raising rates, the US recovers from a quick slowdown and the market then goes to new highs? How about those personal tax receipts then and the prospects for a diminished budget deficit? What if necessary policies are put in place by countries with shrinking populations, such as Japan (it's being considered), Germany and Russia (Putin has proposed some)? Growing populations mean growing economies. More demand. More demand for diapers anyway. What if Paul McCartney finds happiness again, but this time with a pre-nup?

What if, as mooted by Business Week, the US pension situation improves as increased contributions and a high return on investment help to close the gap?

Life on the Wire

Herb is often asked why he left the practice of law some 27 years ago as a partner of a prominent firm. He always replies that, if he knows anything, he knows he has a low threshold for monotony. The challenges of the investment business are unique—he claims to enjoy every moment of every day. Except the down moments. Making money for our clients and ourselves is important, but being right is the ultimate satisfaction. At Trapeze our hobby is our work. We are all obsessed about what we do and strive to be right. Our good friend, novelist Martyn Burke, speaking of our name change to “Trapeze” noted that The Flying Wallendas, made this wonderful existential comment: “Life is on the wire. Everything else is just waiting.” That could be us too.

Herbert Abramson and
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