



## **ACCENTUATE THE POSITIVE**

An ugly time since our '07 highs. Not just for us, but for value managers generally. Some renowned ones too. There is a formidable list of highly regarded US and Canadian value managers currently down more than 20%—some over 30%—from their '07 highs. Misery generally loves company but it is small comfort that we performed badly despite being in good company. Lots of disappointment and stress. It is likely easier for professional managers to endure the stress of declines than for most of you. We have an in-depth understanding of the individual positions in the portfolios which, as value investors, increases our long-term confidence as their values become even more attractive. But it's a well known phenomenon that humans suffer roughly twice as much from losses as they receive pleasure from comparable gains. As a consequence, the reasonable expectation of superior future returns is rejected when recent results have been poor.

We've been here before and invariably, after a poor performance period, rooted in an overall market decline, our best upside performance has followed. We are in the right groups. Overweighted in Energy (with oil at a record high over \$100 and natural gas at two year highs), and Golds (with gold at record highs), some other resource plays (with their commodities strong too), a cheap defense stock and some cheap, beaten up retailers. Many are smaller caps and went down much more than the market as investors avoided those kinds of stocks. We think those stocks will rise more quickly in the market recovery. Especially since valuation differentials within our favoured groups, between large and small caps, is unsustainably wide.

History is on our side too. Market declines tend to be brief in duration and volatility is greater on the following upside than on the decline with the rebound typically very substantial in the first three to four months after the bottom.

### **Accentuate The Negative?**

Bing Crosby's hit song, "Accentuate the Positive", was a plea for positive thinking, of the kind we could all use now. But market participants, after selloffs such as we've just had, tend to do the opposite—focus on the negative. Because fear is a more powerful emotion than greed, most investors tend to believe the worst and disbelieve the best.

Yes, the global economy is slowing. The US may be going into a recession or may already be in one, brought on by the collapse in housing which is causing a slowdown in consumer spending. Yes, there is a serious credit crunch ongoing started from the defaults in US securitized mortgage debt. Central banks have been making emergency liquidity injections and lowering rates, but the doom and gloomers say lower rates won't help. They say more bank writedowns are coming and that financial losses in the whole financial system could reach more than \$1 trillion. They say house prices, down 9% currently, could fall 20% to 30% before bottoming. That labour markets will be weak with no new jobs and no rise in real wages. And that the dollar will collapse. The bears expect the recession to last for another year and that it will be poison for market performance. The ultra pessimists worry about a financial system collapse, massive job losses and an economic depression. Greenspan caused it and Bernanke doesn't get it. On the other hand, BCA Research says, "Loan data and the refinancing index do not confirm such pessimistic sentiment, but investors are in no mood to believe anything but negative news." Worry Warts.

### **Eliminate The Positive?**

What the worry warts are ignoring is that the economy is undergoing a healing process that will make things better, likely showing up in the second half of '08. No question, credit is tight and delinquencies are rising. \$146 billion in asset writedowns and credit losses at the world's largest financial firms. But US interest rate cuts will ease credit conditions, allow banks to cleanse their balance sheets, homeowners to reset mortgages at lower rates and new home buyers to snap up bargains. Over \$100 billion of new capital has been injected into struggling banks and the yield curve is positive, a favourable lending environment for bank profitability. Mortgages are available for those who *should* have them. The bubble in housing is being corrected and will likely run its course in the US more quickly since new home inventories are declining (at just over 500,000, the lowest level in two years), the cost of building a new house is increasing with general inflation, and every red-blooded American covets one. Applications for US home mortgages (2/3 for refinancing) rose recently to their highest level since March '04 as the average 30 year mortgage rate recently fell to its lowest level since June '05. Look for it to fall further. And unlike most countries, including Canada, US mortgage interest is tax deductible. We properly bemoan the drop in building permits but, on the other hand, that means fewer housing starts. Bottom line, home inventory will continue to drop with improved affordability and fewer new homes coming on the market.

The US consumer was overindebted with savings rates at historic lows. As spending is reined in relative to earnings which continue to improve, savings increase and generate the wherewithal for future spending once confidence improves. When the mileage is through the roof and new tires and brakes are needed, just watch how fast the consumer will spend for a new set of wheels, especially if it's better on gas.

Recent Fed meeting minutes indicate a recognition of the slowing economic growth, intensification of the housing correction, softening of business and consumer spending as well as strains in the financial market. So, look for even lower interest rates and even more liquidity.

The Government is helping the cause too with a \$168 billion stimulus plan, with rebate cheques to start being mailed in May to most of the nation's taxpayers. Help for Q3.

The US trade deficit, long a drag on the economy, improved 7% in December from the previous month to \$58.8 billion, from reduced imports and rising exports, the result of slower domestic demand, a still strong global economy and a more competitive US dollar. Strong capital inflows continue to finance the current account deficit. By contrast, Canada's trade surplus shrank to its lowest level in 9 years and is at risk of its current account dipping into deficit for the first time in a decade thanks to the unprecedented run-up in the Canadian dollar from its lows of just 6 years ago to par with the US unit. Nevertheless, Canada added 46,400 new jobs in January, returning its unemployment rate to its 33 year low of 5.8%. Yet the Bank of Canada is still talking rate cuts.

The global economy is still strong (the International Monetary Fund forecasting '08 global growth at 4.1%), especially with the fast growing emerging countries—China (expected to still grow 9.6% in '08), India, Brazil, Russia, Mexico. US productivity continues strong, up 1.8% in Q4 '07, and US competitiveness will continue to improve, with rising foreign trade offsetting weakness in domestic spending.

Though retail sales are sluggish, they are by no means a disaster—probably better than expected—and retail stocks seem to have bottomed, as they've discounted the worst. An unexpected rise in US retail sales for January on higher sales of new cars, gasoline and clothing gave hope the US might avoid a recession. Even as Best Buy cut its earnings guidance by about 3%, it said it would open 85 to 100 new stores in the US and 40 to 50 stores internationally, adding 12,000 retail jobs. Some recession.

Merrill Lynch's chief economist believes the US is in the early stages of a manufacturing renaissance resulting from, among other things, the improved US export competitiveness from the depreciation of the US dollar over the last 5 years. Merrill Lynch really "is bullish on America", even though America, right now, is bearish on Merrill Lynch. US competitiveness is also improving because costs in China are rising making it somewhat less competitive.

The Baltic Freight Index, a measure of the flow of goods, has shown significant strength over the last couple of weeks. The Dow Transports, a good indicator of economic stability, has been improving. Housing stocks too. Commodity prices have held firm despite the apparent slowdown, the CRB Index recently at a record high and Dr. Copper, the renowned economist, is up to a recent high of \$3.86/lb. On the other hand, rising food and energy prices are creating inflationary pressures which could reduce the outlook for monetary ease, but should be balanced with the deflation in the real estate sector.

In terms of the credit crunch, Libor and Ted Spread numbers indicate a real easing of internal pressure on the financial system. Compared to the condition of households, the financial condition of US businesses looks good, with leverage in aggregate modest compared to previous cycle peaks. Corporations are generating high profit margins and strong cash flows. Interest payments and debt due are at record lows. Cash on hand is high, free cash flow is strong and companies are in good shape to withstand a downturn.

The unemployment rate of 4.9% is currently consistent with a full employment economy. It will probably rise, to maybe 5.5%, but that's hardly a crisis. Average hourly earnings continue to rise. Though layoffs have been rising, job cuts are still running far below the US recession from March through November '01, suggesting the housing market's problems still have not spread much beyond financial services and construction. Corporate earnings are still expected to rise even in Q1 and Q2. Only the Financials are in negative territory, although the Consumer Discretionary and Materials results are at less than 3%. Not so bad if it's a recession.

Overall growth is inching up and the S&P 500, in aggregate, is growing its EPS at almost double-digit rates, with the highest from Utilities, Energy, Health Care and Tech. Exxon Mobil just recorded the largest annual profit in American history, earning \$40.6 billion. No. 2, Chevron, also had its best year ever with profit of \$18.7 billion. Exxon also paid \$21 billion in taxes, equal to what the lowest 65 million US taxpayers paid in total. The steel industry continues strong. Deere and Caterpillar are doing well too as global infrastructure growth continues and farm equipment sales are through the roof. Hewlett Packard reported better numbers as the emerging world is offsetting weak growth in the US and Europe. Commodities are at all-time highs and the stocks of their producers should do very well. Some recession.

What Fed Chairman, Bernanke, recently estimated as a \$100 billion loss on subprime loans, would represent only 0.1% of the \$100 trillion in combined assets of all US households and US non-farm, non-financial corporations. Even if they turned out to be 5 times that, it would still only represent 0.5% of total US assets.

US net worth is now more than eight times the country's GDP—the highest multiple in 50 years, always having grown faster than GDP. Total US debt is manageable at less than a third of total US assets. On a per capita basis, net worth, adjusted for inflation, at the end of '07 was \$360,000, compared to \$300,000 in '00, \$256,000 in '90, \$220,000 in '80, \$150,000 in '70 and \$110,000 in '60. Who would bet against that track record?

### **“Latch On To The Affirmative”**

Warren Buffett claims he pays no attention to the economy. He merely buys undervalued companies to hold for years. If he was so smart, wouldn't he be rich?

As value investors, we sort of subscribe to that concept, but we still want to be in the groups or stocks where we'll be treated the best and that often depends on our macro views too.

The market is cheap and, odds are, has bottomed. The stock market discounts future events, and bottoms well before the economic downturn has ended, usually leading GDP turns by 6 to 9 months. Autos and housing have been in a recession for six or seven months and trough earlier than any other sector in a recession as the bad news is priced in. The sub-prime news is getting stale.

Further, investing in an evident slowdown, though contrarian, makes sense. The S&P actually went up during 6 of the last 11 recessions.

Even if investors generally don't recognize and take advantage of the unusual values this market presents, corporations will and are. So, Microsoft is bidding \$44.6 billion for Yahoo—a 60% premium to its trading price yet still not high enough apparently. Miner Xstrata turned down \$76 million from Brazilian suitor, Vale, seeking \$95 billion. With credit tight, mergers and acquisitions activity has generally been weaker, but we expect it to pick up as the credit environment relaxes. There is \$1.1 trillion in corporate cash on the books which should help support buybacks and mergers and acquisitions. IBM just announced a \$14 billion share buyback. If smaller caps are cheaper than their larger cap brethren, look for them to be gobbled up. Look for the bigger and stronger guys to strengthen market share at the expense of their weaker peers. Best Buy over Circuit City. Darwin lives. And look for ultimate margin improvement from the benefits of consolidation and cost cutting. Recessions are a diet for the overweight. In the end, business becomes leaner and meaner.

We don't know for sure whether we're in, or will soon be in, a recession. Big deal. A modest amount of growth or a modest amount of negative growth for 2 or more consecutive quarters. Again, we do know the market will likely move well ahead of the end of the economic decline.

So we need to go with what we do know. While no bell goes off at market bottoms we need to own good businesses when they are as cheap as they've gotten. History suggests turns can be fast and furious. So we need to be "in the game" even though it's tough sledding.

We believe that there is not material downside left in the overall markets after their significant declines. The S&P 500 at its worst was 16% off its '07 high; the NASDAQ was 22% off its high; Value Line down 24% at its worst; the Russell 2000 Value Index (small caps) was down at its worst 27% to book value (its 2002 valuation low); in Cdn\$, the S&P TSX was down 17% and the TSX Venture Exchange (primarily small cap resource companies) down 29%, at each of their respective lows. In our SVA™ work, most of these, indeed most markets around the world, have hit or bounced up from "floors".

Most important, valuations are compelling. S&P 500 earnings for '08 are expected to be \$99 and earnings guidance is in line with expectations. That means the S&P 500 is trading at only 13.7x those earnings, a 13 year low. Great companies at great prices. The P/E has not been this low since 1991, and other than 1972-1984 (a high inflation/high interest rate period) the S&P 500 has not traded below 15x trailing earnings since 1958. Even if S&P earnings dip, we expect them to be back to their trend line of 7% growth, at \$114 by 2010. The real valuation case is made by comparing even the expected lower '08 earnings with the current 10 year US Treasury return of 3.56%. The current earnings yield (earnings as a percent of the index price) of 7.3% versus that treasury yield is the widest disparity in the more than 60 years since WWII other than during 4 excessively high inflation years of the 1970s. Even if interest rates were to rise from 3.56% to 6% in 3 years, and earnings revert to their trend line at \$114, the S&P 500 should trade at 1900 (16.7x those earnings) for a 13.7% 3 year annualized return including dividends.

Stocks are an outstanding value relative to bonds, even if earnings were to decline more than expected, to say, as low as a 6.5% earnings yield, the level that stopped the '02 bear market when the NASDAQ fell nearly 90%, the worst decline since the 1920s. Insiders also think stocks are very cheap and have been buyers at levels of strength that typically mark a major bottom. And, on top of that, our stocks are even cheaper than the market. Most of our largest holdings fell to “thumbprint lows” (price to Adjusted Book Value levels) that have only occurred at previous major lows for these individual stocks in past years.

Sentiment indicators are as bad as it gets. Pessimism is rampant. Recently, more than twice as many bears to bulls—a level that has marked previous lows. Advisory Sentiment, a measure of market letter writers, revealed only 37% bulls, a level just above the '02 bear market low. After months of decline the Smart Money Index is now rising strongly. The number of stocks making new lows is less than the bottom in January. The Rydex Ratio, which measures the public purchases of bullish funds vs. bearish and money market funds, supports a bottoming market. The amount of cash on the sidelines in money market funds is a record \$3.4 trillion, even higher than '01, and higher than the 4 occasions since 1980 that marked major market bottoms. The IPO market has, understandably, shrunk and buybacks should pick up, keeping the supply of equities diminished for whenever the demand returns.

Importantly, the monetary environment is favourable for stocks, with the Fed having lowered interest rates by 225 bps since last September to 3% (125 bps in a recent 2 week period) and likely to lower rates further. Money supply is growing at a stimulative 15% annual rate of increase. And the yield curve is very positively sloped with the 10 year Treasury yield of 3.56% a whopping 95% higher than the 90 day T-bill of 1.83%, suggesting bond buyers are anticipating an improved economy, or higher inflation, or both. In whichever case, stocks will be better than bonds.

As value investors, we need to be contrarian; we need to look for opportunity in out of favour groups or stocks because that's where the bargains are. When stocks generally are out of favour, including many of the world's best companies, it's a contrarian, value investor's dream. Talk about kids in a candy shop. Our contrarian stance served us in good stead during the bubble of '00 when we shorted overvalued stocks, such as Nortel, at unprecedented valuations. Kids in a candy shop.

### **“Don't Mess With Mister In-Between”**

Valuation today is compelling. It is waiting to be rewarded. If we liked our companies in October when the decline really started, we love them to death now. Our oil and gas names are now more prospective than they've ever been from the company-specific progress and the fabulous price of oil and improving price for gas, both of which we believe are going higher. In fact, the energy group is still the most undervalued S&P sector at just over 10x expected '08 earnings.

*Corridor Resources* has had a significant decline from its high of \$12.25 back in May after encountering some delays in drilling results in its prospective New Brunswick Frederick Brook shale zone and at its Green Gables well in PEI. At its current price of \$6.20, we're getting Corridor for less than half of what we believe the development assets alone should be worth over the next 2-3 years, and that's without natural gas prices rising to the levels we expect. Corridor will drill another 90 wells in its prolific upper Hiram Brook field alone, where it has yet to hit a dry hole. Capital expenditures this year are set to be \$71 million. Should the company have decent exploration success then our risk-adjusted Net Asset Value (NAV) of \$18 will be realized or exceeded. If it is successful in proving that the Frederick Brook shale zone is commercial and/or if the deep Dawson Settlement zone, which it is currently drilling and at which it should be at depth in a few weeks, is gas bearing and tests commercial, the NAV could be much higher.

*Orca Exploration* is currently producing gas offshore Tanzania for electric power generation and industrial use. It has capacity to produce even more as demand increases, especially for power starved Africa, and is waiting for the government to set higher gas rates than the company has been receiving. It is trading at 10x this year's cash flow which should rise to \$1.50 per share in '09 and \$2.00 per share in 2010, making it cheap on an expected cash flow basis. It is also receiving the results of seismic work conducted on a couple of exciting oil exploration targets in Uganda and could make drilling decisions by April. Remember, this is the same exploration team that was so successful at Pan-Ocean in Gabon, and they believe Uganda may be even more prospective. Though Orca's share price fell as it encountered some industry delays in gas plant expansions, its 52 mmcf/d well discovery offshore Tanzania was spectacular. With its large, long life gas resource in Tanzania, a steady cash flow stream and minimal capital requirements, returns for shareholders should be reliable with the added potential for exploration success. Our 3 year target is double the current share price which could come sooner with exploration success.

*Pacific Energy* should more than double its production to 15,000 bpd over the next 12-18 months from its offshore *development* oil fields in California and Alaska. The company trades at one-fifth of its NAV which is astonishing in and of itself, but especially so given the company's long life (over 25 years) reserves. The market has penalized the company for issuing too many shares and incurring too much debt to acquire its Alaskan assets. Debt renegotiations postponed payments until early '09 which allows the company ample time to repay its obligations via asset sales, a refunding of its bonding, a refinancing or a combination thereof. At 15,000 bpd, annual cash flow should be over \$150 million, easily justifying a doubling in the share price.

At *Petrolifera*, the value of the proven reserves alone supports the share price and we are effectively getting all of the exploration prospects free. With over 7 million acres in Argentina, Colombia and Peru, the company has significant exploration upside. The risk-adjusted NAV is double the current share price. The company's share price fell recently as production dropped off when pressures declined naturally at its Argentina field, and because Argentina lowered the oil export price (a decision rumoured soon to be shortly reversed). Low risk waterflooding and development (read: not dependent on exploration) drilling are expected to bring production levels back up. *Petrolifera* continues to increase reserves and production should increase 50%

by year's end, at which point annualized cash flow should be \$125 million. By year end the company should also be drilling exploration wells in Colombia and Peru where the prospects, particularly in Peru, are massive.

*Sterling Resources* has made two significant discoveries in the last few months—in the North Sea and offshore Romania. The risked NAV of the company is almost double the share price and should grow materially over the next 3 years. The company should grow its production by 2010 to 20,000 bpd and its cash flow to \$150 million or \$2.25 per share (nearly its current share price) *from development alone*. 2011 cash flow is expected to be \$340 million. For perspective, based on the current share price, the entire enterprise value of the company today is only about \$250 million. The company should trade at 3 to 4 times its current share price by 2010 with even more upside from potential exploration success.

*Canoro Resources* has moved up recently but still trades for only the value of its proven reserves. That value, however, should be driven substantially higher with a multi-well development program at its Amguri field in India, facility upgrades, further zone completions at existing wells, potential for higher negotiated natural gas prices, possible exploration success and the likelihood of acquiring additional exploration lands. Meanwhile, the shares trade for half of their risk-adjusted NAV, allowing for significant upside potential.

*Connacher Oil and Gas* also has a very long 25 year reserve life and also trades at a severely discounted price. Connacher still appears to be the least expensive way to invest in Canada's Oil Sands. The company's stock price still has yet to recover from the perceived impact of the Alberta royalty changes last Fall. The company is ahead of schedule with production from its first Oil Sands pod which was completed not too far ahead of its estimated cost versus its peers who overspent considerably. It has managed to execute on its integration strategy with its natural gas assets feeding the steam process enabling the heavy oil to flow to surface and then utilizing its refinery to help eliminate the exposure to heavy oil price spreads. The company was able to obtain \$600 million in project debt financing to bring on its second pod (approval for which could come as soon as the second quarter) thereby minimizing future dilution and financing risks/delays. With over \$200 million in cash flow expected in '09, the company should trade for at least 6x cash flow or double the current share price. A material reserve increase was just announced taking the company's proven and probable reserves up over 100% for '07.

*Allen-Vanguard* epitomizes our recent performance. The company has delivered on all fronts yet the stock price has performed dreadfully. Unwarranted we think. The company's defense business should continue to grow even if the economy weakens. It acquired its nearest competitor, Med-Eng, creating a dominant supplier of counterterrorism products and services, including bomb jammers, bomb squad training, remote operated vehicles (robots), containment systems, and personal protection equipment. Minor development dollars, awarded to 3 of its potential competitors for Crew 3, the next generation of IED jammers, spooked the market. The same occurred in the past with Crew 1 and 2, but the actual procurement dollars ultimately went to the incumbents. Allen-Vanguard expects to win substantial business and should have Crew 3-ready product well ahead of the 2010 expectation.

The company recently had to renegotiate its lending terms on the financing it got in September for its Med-Eng acquisition. A lumpy order pace was to blame. However, the US Navy orders expected by the end of '07 have now materialized and other substantial orders are expected over the next couple of months. The stock trades at less than half of its peers' multiples and a third of our appraised value, completely misunderstood by the marketplace. As new anticipated orders materialize and as earnings become more visible, we believe the stock will once again begin to move up towards fair market value.

*CompuCredit* is our most controversial stock. First, if only because it's a dreaded Financial. Second, because its customers are sub-prime credits (though of credit cards, not mortgages). Clearly, we should have waited to buy this stock. Access to capital to grow in the Financial space has been more difficult than we anticipated. That said, the US housing downturn should not adversely affect CompuCredit since 75% of its customers don't even own a home. The company has over \$200 million of excess liquidity and stands to benefit as the sole bidder of credit card portfolios from distressed competitors. The company's book value, which actually increased in the December quarter, is 60% above the share price. We believe the company will once again be growing at a good pace by year's end. Even if its current book of business grows slowly, the purchase of a new portfolio and the inherent high profitability of its existing book of business should drive earnings much higher by year end.

In the next few months, when the company accesses additional lines of credit to fund the growth of its business, we expect analysts to move their earnings estimates and target prices higher. At around \$10, the stock is very undervalued with \$3 per share of near term earnings potential and future earnings power of over \$5 per share. Management owns more than half of the shares and insider buying has been considerable.

*Office Depot's* business is somewhat more cyclical than we thought. However, we do believe the worst will be behind the company after the first half of '08, and over the next 12-18 months the earnings power should become more visible. In our own research models, we've conservatively assumed anemic sales growth and still get a healthy 3 year target based on the levers the company can employ to achieve better margins and higher earnings. The company is worth 14x forward earnings yet trades at only 12x depressed earnings. Our Fair Market Value for it today is over 50% higher than the share price. With \$2.50 of earnings expected for 2010, we expect the stock to more than double over the next 3 years.

In January, we believed that retail stocks were putting in a significant bottom as the retail index was trading at 2x book value, a valuation level not seen since the last bear market. We have added to our retail holdings where accounts had cash or could comfortably incur additional leverage. One purchase was *DSW Inc.*, a leading shoe retailer. DSW has the ability to continue growing its store base by 10% per year and boost profit margins, even with a challenged consumer. Like tires and brakes, shoes wear out and must be replaced. At our purchase price, the stock was trading at about 9x '08 earnings and we forecast a potential annualized return in excess of 30% over the next 3 years.

Another retailer we bought, *The Children's Place Retail Stores*, provides a very similar opportunity. Children's Place is less vulnerable to economic swings as its customer base consists of growing children who are constantly in need of being re-outfitted. Tell us about it! Shortly after our purchase, the former CEO filed that he was considering a bid of \$24 per share for the company. Our appraisal shows a current value closer to the mid-\$30s and a substantially higher figure as the company grows its square footage and profit margins over the next few years.

We also bought *Walgreen*, a "great company", having gotten down to a "floor" at 2.7x adjusted book value, with the general decline of big cap companies. The company has only traded as low as that valuation 3 times in the last 20 years. In fact, other than the last few months, it has not been undervalued during the last 10 years. At 13x '08 earnings, a 30% discount to our appraised value, this consistently growing drug store chain is a quality large cap addition to the portfolios.

We do not recall a period where the analysts of brokerage firms have had 1 year targets for the share prices of our holdings as high as they are today. Here's a summary of the average of the analysts covering each stock's 1 year price target for our top 10 holdings:

<u>Company</u>	<u>Price</u>	<u>Analysts Average One Year Target</u>	<u>Target Return</u>
Allen-Vanguard	\$4.36	\$10.56	+142%
Canoro Resources	\$1.74	\$3.16	+82%
CompuCredit	\$10.44	\$14.50	+39%
Connacher Oil & Gas	\$3.62	\$5.20	+44%
Corridor Resources	\$6.20	\$11.21	+81%
Etruscan	\$2.21	\$7.30	+230%
Orca Exploration	\$10.00	\$15.25	+53%
Pacific Energy	\$1.74	\$2.97	+71%
Petrolifera	\$11.72	\$17.15	+46%
Sterling Resources	\$2.96	\$4.91	+66%

To put these *1 year only* upside targets in perspective, Value Line Investment Survey has a 70% appreciation potential for the 1,700 stocks in its coverage universe, but *over the next 3-5 years*.

## **Income Holdings**

Our income accounts have held up well during the equity market correction of the last few months, though we have been disappointed with their performance over the last 3 years. We did suffer the odd capital loss and have enjoyed little in the way of capital gains to materially augment the interest income. Currently, the income holdings yield about 9% and we do expect some capital gains to materialize. Approximately 70% of the holdings are convertible securities or Real Estate Investment Trusts which stand to benefit as their underlying businesses move forward.

### **“Bring Gloom Down To The Minimum”**

There is considerable evidence that the market has already bottomed—even if the economic slowdown does continue for several more months. And the ensuing market recovery can be rapid.

Stocks have historically returned 10% per year, with value investors doing better at about 11% per year, and we seek to outperform, with a 12% or higher target, which our track record has surpassed since its inception almost 10 years ago. Our growth accounts have enjoyed positive returns in every full calendar year of our operations with the exception of '07, attributable to the awful last two months of the year. We expect '08 to be a profitable year too. Not just because the market will reverse but because our portfolio of now ultra-cheap stocks will become more fairly priced, even if based only on their specific business achievements. Clearly, downside risk now is not nearly as great as last October when the selloff began. We made some mistakes for sure, taking off shorts prematurely, but we are in the right groups with very cheap stocks that have declined primarily from market volatility. That same volatility will, in due course, sooner we think than later, work in our favour. The good part of the market decline is that it's behind us. We want to be fully invested and then some. And, needless to say, not be short when stocks are too cheap to be shorted and we think a recovery is on the way. This is a time of opportunity, not a time to be feared.

Bing's lyrics are a tonic for panic-stricken investors:

*“You've got to accentuate the positive  
Eliminate the negative  
Latch on to the affirmative  
Don't mess with Mister In-Between.”*

If investors still can't, as the song recommends, “Bring gloom down to the minimum”, they should try “dreaming of a white Christmas”, because we're confident that by then we'll be well into the recovery.

Herbert Abramson and  
Randall Abramson, CFA  
February 29, 2008

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