TRADEOFFS

Rules, shmules. Warren Buffett says, there are only two rules to investing. "Rule No. 1: Never lose money. Rule No. 2: Never forget Rule No. 1."

That's what value investing is about. Not losing. That's why we are compelled to buy low, so that there is not as much potential for loss. And, though Mr. Buffett doesn't believe in diversification, claiming that it's an admission that you don't know your investments adequately, as mere mortals, we do diversify, again, to minimize loss. To make sure that, despite oodles of analysis, the inevitable mistake doesn't turn into a torpedo.

There are no other rules. Well, perhaps, one more. That is, to always use common sense, which that other pundit, John Templeton, claims is a very uncommon thing.

The Proof of the Pudding

We try not to be hidebound by the rigid conventional rules that business schools and consultants accept as received wisdom. Buffett's sidekick, Charlie Munger, just said at Berkshire's annual meeting, "At least 50% of the information taught in finance courses is twaddle!" Regrettably, despite our growth accounts' 30% multi-year track record, we occasionally run into criticism for deviating from the rules, from the norm, from the twaddle, from the prescription for mediocrity. We recently had such an experience with a US consultant, despite his client's exemplary returns with us. What is that wisdom? "Avoid illiquid stocks." "How many days would it take to liquidate, if necessary?" "No more than 5% in any one stock or 10% in any one sector or group." "Never own more than 10% of a company." Tell that to Bill Gates, the world's richest man. Or to the Oracle of Omaha, Warren Buffett, the third richest, who claimed last weekend his company is now prepared to buy "a big business outright". You can't get more concentrated than 100%. To continue with the doctrine: "Keep some bonds for balance and some cash for firepower in case the market declines." "The market knows all, it's efficient, so join it, don't try to beat it." "Short sales are too risky because the price can rise infinitely."

Consultants tell us that illiquid stocks, excessive weightings and concentration in groups can lead to greater volatility, "beta" in consultant-speak, which they equate with risk. Hopefully our clients understand that while we may, from time to time, get some inordinate volatility, it's usually a temporary fluctuation in an ongoing rise. We don't equate volatility with risk. Indeed, those very fluctuations can often be an opportunity to add more shares at favourable prices or to trim holdings back on an inordinate rise.

Rules, shmules. Consultants, conshmultants. A prescription for underperformance or at best for closet indexing. If we followed that prescription we'd have mediocre performance like most money managers, since two-thirds of them don't beat the market over most periods. What's that adage? If you do what everyone else does you'll get what they got.

Well thank goodness we haven't, and don't, and have the track record to show for it. The proof of the pudding is in the eating. Not everyone knows, or gets, the recipe.

Tradeoffs

We know when we're buying a stock that's illiquid. We know when we're overweighting, concentrating in a name or emphasizing a group. We agonize over it. There's obviously some risk that it'll take longer to liquidate an illiquid name if you need to exit—more an inconvenience than an outright risk. And, that if you have a higher proportion of one stock or of one group you're more exposed if you're wrong. We don't assume those additional risks lightly. But, as in most worthwhile things in life, there is a tradeoff. Especially if you are a value junkie. These risks are calculated. Some things we won't trade off no matter how ostensibly cheap the stock is. We avoid political risk—we don't invest in Venezuela or Ecuador, even for potential five baggers because the government might confiscate it, and you'll be left holding the bag, or all five bags. We don't invest with managements we believe are untruthful, where the accounting is suspect, where environmental or operating permits may never be forthcoming, or in sectors or companies we can't fathom.

But we very often trade off value for a modicum of calculated risk. By way of example, when Pan-Ocean, a very illiquid stock, was 6 years ago trading at under $2, had no liabilities and had more cash per share than its share price, and you were getting for free its oil properties in Gabon, with their considerable potential, that was a worthwhile tradeoff. Incredible value traded off for illiquidity. And value for patience too. Six years later, shareholders ended up with $71 a share after factoring in the Orca Exploration spinout, which we still own and is making new highs.

We normally have 3-4% weightings in any one stock. Unless we *really* like it. Unless there's a really big upside without, in our opinion, much downside. So, for example, in Corridor Resources, we've just raised our starting weighting for a new account to an over-weighted 7%. It's not the most liquid stock and it only has a market cap of about $900 million. And we're happy to say our clients own 14% of it, making us its second largest shareholder after our equally imprudent friends at Sprott Asset Management. The stock trades at $12, an all-time high, up from a 52 week low of $4.35. But it has a huge upside potential with not much relative downside. It just completed its 21st consecutive successful gas well in the Hiram Brook upper formation and will commence production mid-June through the new pipeline it is completing to hook up with the Maritimes & Northeast Pipeline. At current gas prices it should cash flow $2 per share in '09 from the Hiram Brook formation alone. So, if we're wrong about the upside, at current applicable multiples, it should at least trade at today's price in 18 months without any further exploration success. Sure, some risk, inasmuch as time is money, and we might take a temporary hit. But it has an excellent balance sheet and outstanding management. It is in New Brunswick, a hospitable jurisdiction, where provincial royalties are 40% of Alberta's and the gas price $1.00 per mcf higher because of its proximity to the best gas markets in the world, New England and New York. Yes, illiquid, and small cap—but relatively safe. Now for the real upside. It is about to test a deeper fractured dolomite shale formation called the Frederick Brook

which it recently encountered drilling for a yet deeper targeted sand formation known as the Dawson Settlement which it never reached because of equipment limitations. It intends to drill a deeper well into the Dawson Settlement later this year. But if that middle shale formation tests commercial, which we should know in September, we're off to the races. Oops, we mean, in consultant-speak, we're off to an above average annualized risk adjusted rate of return.

This stock has huge potential if the Frederick Brook is commercial and if the Dawson Settlement zone is gas bearing. Once it is cash flowing, Corridor will also exploit, over time, exciting high impact exploration prospects it has in Prince Edward Island and the Gulf of St. Lawrence. Limited downside, huge upside potential. A great tradeoff for illiquidity and concentration. Whoever said "go west young man" never knew about the exciting prospects in Eastern Canada.

Sometimes Less Is More

Value investing is not just about bottom up stock picking. We wouldn't buy a cheap buggy whip company. If you thought the world were coming to an end and wanted to own safe dependables, say a toilet paper company, it's got to be big cap. Kimberly-Clark, Procter & Gamble. If you want to own necessaries, such as drugs, it's got to be big cap. Johnson & Johnson, Glaxo. If you like autos, it's got to be big. Ford, GM, Magna. But if you like resource companies, they don't have to be big and liquid. And we like resources. Oil and gas. Precious metals. Base metals. We're not even sure that bigger isn't in some respects a disadvantage when it comes to resource companies. Resource companies deal with depleting assets that need to be replaced—much harder when you're bigger. How does Barrick, the world's biggest gold producer, replace eight million ounces of gold produced annually? Newmont, the second biggest, just reported lower earnings on lower production. To maintain production, bigger companies are then driven to take on country risk to replace depleting resources—Newmont in Indonesia, or the big oil companies in Venezuela and Ecuador, fighting off rabid nationalization. More dependent on higher commodity prices because of bigger overheads and cost structures. Costly oil sands plays that may not work at lower prices. Whereas our smaller companies grow with the drill bit and don't require commodity prices as high as currently in order to be profitable. And a modest discovery which might not be meaningful to the big guy can be momentous to the smaller company. Sometimes less is more.

There are always unknowns when you buy any stock—the down cards—no matter how rigorous the analysis. A surprise can be company specific or a macro event. But, it seems to us, smaller companies, with fewer divisions, fewer people, and fewer components, are easier to understand. Go figure GE with operations as diverse as gas turbines and NBC. Simpler, easier to understand, stories are a tradeoff for their smaller size. Simple stories for simple investors.

Smaller caps breed familiarity. While we're unlikely to get the managements of Kimberly-Clark or Procter & Gamble to meet with us, we doubt there's even one senior management of any of our oils and golds we don't know personally. An opportunity for us to assess their skills, to be better informed and where we are able, to influence them for the benefit of our client shareowners. We know, first-hand, that Norm Miller, President of Corridor, is smart, experienced, cautious, not promotional, dedicated and trustworthy.

Then, too, obviously fewer analysts cover a smaller story and fewer, too, would be its institutional shareholders, allowing it more likely to be inefficiently priced—the bargain we seek. To add value we need to have an edge. It's hard to have an edge investing in Google. If it is received wisdom by the investing community that illiquidity is to be avoided, then, a fortiori, the demand for the like should be less, and therefore its value enhanced.

Unlike personal relationships, where the most popular guy or gal is the most desirable, in stock picking, we look for the ugly ducklings, the unpopular, who we think will ultimately turn into swans.

If illiquid stocks are generally bad to own and to be avoided, is the converse true, that they would be good to sell short? Or, are they a category to be avoided, in either case, because of their potential volatility and difficulty of exiting the position, long or short? Not, so to speak, for the faint of heart. We confess that we are not faint of heart—nor faint of guts—nor of judgment. We just want to buy low and sell high. Period. Orthodoxy be damned.

Interestingly, our best success with short selling has come from shorting the bigger cap, highly liquid names that we're told tend to be more attractive. Nortel, American Airlines, United Airlines, Toll Brothers, Apple. But the list could have included Ford, Fannie Mae, Lucent, Bombardier, New York Times and the drug stocks.

Smaller resource companies have another edge in that they can more easily be taken over by a bigger one which seeks to replace its depleting reserves by acquisition. No one is going to take out Exxon. But Corridor will be a juicy target as it continues to grow its resources. Just as Pan-Ocean and La Senza were for their larger acquirers.

Success breeds liquidity. As our illiquid companies grow and their share prices rise, they become more liquid. Our experience has been they're a lot tougher to buy when we started because they were illiquid, but much easier to exit as liquidity is enhanced on the way up.

All that being said, we don't have a small cap bias. We have a value bias. And if it's the energy group where we find the value, and if within that group the smaller companies are the standouts, be assured that's where we'll be.

Avoid Some Big Caps

Indeed from an economic macro standpoint, we have some concerns that some groups, those which are, of their nature, populated by the big caps—i.e., the financials, the utilities, the big retailers, the autos, the REITS—may have some headwind from the possible onset of stagflation, the worst of all worlds, a slowing economy and the prospect for rising interest rates as inflation picks up.

The US is clearly slowing. Its economy grew by only 1.3% in Q1. Nonfarm payrolls for April grew by only 88,000 jobs with drops in homebuilding, manufacturing and retail, and the unemployment rate rose to 4.5%. Wage increases also slowed. But there's a tradeoff. Though the US economy is slowing, foreign economies are growing faster than the US and helping those multinationals that derive a large part of their profits overseas.

Other tradeoffs. Stock prices are dependent on three things: earnings, interest rates and price to earnings ratios. Earnings growth has been coming in surprisingly better at almost 10% compared to the 3-5% anticipated. Much of it, like Radio Shack, from cutting expenses, not from higher sales. But we believe that, as the housing slump continues, it will take its toll on the consumer's ability and willingness to spend and that will ultimately show up in slower earnings growth and be a drag on the stock market.

But there's a tradeoff. Because if personal incomes are constant and the consumer spends less, he automatically saves more, providing future firepower for investment in financial assets and ultimately for a resumption of his spending.

Hold on, there's another tradeoff in the works, because when GDP is slowing, unemployment is rising and the stock market is weighed down from slowing earnings growth, the Federal Reserve is likely to respond, as it always does, by cutting rates and providing liquidity—a positive for bonds and stocks. Bond guru, Bill Gross of PIMCO (the largest bond fund in the world) thinks that will be the case and is bullish on bonds.

On the other hand, renowned strategist, Don Coxe of Harris Bank thinks that inflation is returning, from higher food, energy and metals prices and from rising labour costs caused by a scarcity of workers from poor demographics, everywhere. Accordingly, he thinks the 26 year bull market in bonds is over and that most stock groups, not including energy and gold, our two favourites, are to be avoided.

We think they're probably both right. The Fed may respond to weakness at the outset, helping bond and stock prices, but ultimately may have to address rising inflationary pressures, not only from rising commodity prices and labour costs, but from a declining dollar which may need to be supported with more attractive US interest rates and used to offset the inflationary pressures of higher import prices.

We may need to be nimble. We need to be careful. Markets are making record highs, but so is margin debt. We may need to trade off long-term investing for fancy footwork. Though, at the moment, the markets are still "on buy" in our work and remain undervalued relative to prevailing interest rates.

Embrace Other Big Caps

But, wait, there are other tradeoffs. A lower dollar should make US exporters more competitive. Toyota may finally get some competition from GM. And the US trade deficit should, after the initial bump we're seeing now from rising import prices, start to decline. Travel to the US will be cheaper for foreigners. Disneyland, a bargain? More help for the trade deficit and the travel and hospitality industries. Even better, US stocks and capital assets generally will become cheaper and more attractive to foreigners. Remember when the Japanese were buying every US asset in sight, including Rockefeller Center and Pebble Beach. Tradeoffs.

By the by, we're not making the case that less is always more. That small caps are generally better than big. That illiquidity is something invariably to be desired. To the contrary. All things being equal, bigger is better. Bigger companies often have more staying power and don't

depend on external financing as much. But all things are rarely equal and, as we always say, we go where we're treated the best. If it is resource producing smaller cap companies, so be it.

Our Smaller Caps

As our firm grows, the size of the companies we can fit our clients into, by definition, will need to grow too. Sometimes we have to pass simply because a company is too small. Though we do prefer the liquidity and theoretical staying power of larger companies, we find it difficult to resist small companies when the values are truly compelling. So, in the first quarter of '07, we added to *Allen-Vanguard* in the market and purchased *Resin Systems* and more *Pacific Energy* in secondary issues. Allen-Vanguard's market cap was about $500 million, Pacific Energy's was just shy of $300 million and Resin's around $150 million. Now $150 million is definitely small cap, but not exactly chump change.

Allen-Vanguard's Electronic Counter-Measures device (ECMs) business where they sell software that's combined with Lockheed Martin's hardware for jamming detonation of bombs is just beginning to take off. A contract win for 600 jammers three weeks ago was just increased to 1,000 devices. US$1.4 billion of contracts is being let this year by the US Department of Defense and we expect at least 10% of that figure to come to Lockheed/Allen-Vanguard. An incremental US$2.4 billion could be spent on ECMs this year and US$4 billion for '08 if the current US administration has its way. As well, the company announced a $40 million acquisition in April. With all that, we expect earnings next year to be over $.70 per share making the company cheap at only 7x earnings.

Resin Systems designs composite products using its proprietary resins. They combine fibreglass and/or other fibres with resins (polyester, epoxy) to arrive at cost-effective, high strength, weight advantaged, non-corrosive products. They're initially focused on two markets, rollers for mining conveyor belts and utility poles. Resin's utility poles are modular, half the weight of steel, a quarter of wood and one-sixth of concrete, with the expected life of RS poles being 80 years, compared to 50-60 years for steel/concrete and 20-40 years for wood. The all-in installed cost of RStandard poles is below that of all other competing products without taking account of the associated savings from zero maintenance requirements. The pole market is about US$8 billion annually in North America, and Home Depot Supply, the leading distributor to utilities but which previously never supplied utility poles because of the storage/transportation issues, has now contracted for C$72 million of sales over 24 months starting in July under an exclusive North American arrangement. Resin could earn half its current share price in just over 2 years from the pole and roller opportunities alone and there should be several other market applications for their novel resin product.

Pacific Energy has more than doubled, in short order, from its $1.30 issue price. The company's operations are ramping up offshore California and with lots of growth ahead. One analyst who recently returned from visiting the platforms off the coast of Long Beach believes the offshore assets alone are worth $4 per share. Which means we're getting the onshore California assets and the prospective gas field in Wyoming (where they've just announced positive drilling results) free—and nobody would argue that getting something for nothing isn't good value, small cap or any cap.

Other small cap holdings include our coal bed methane stocks, *Richards Oil & Gas*, *Storm Cat Energy* and *Stealth Ventures*. Each trades at a valuation that does not reflect the fair value of its underlying assets. And, we believe that all three companies will materially grow their assets over the next few years.

Our emerging gold producers include *Etruscan, High River* and *St Andrew*. These small cap companies trade at low valuations with their production expected to ramp up and with good potential for increasing their resources through exploration.

Smaller cap companies, as evidenced by the performance of the Russell 2000 Index of small stocks, have for some years outperformed their blue chip brethren. Until recently. Interestingly, we think a change is afoot that in some respects will benefit some big cap names, namely the US multinationals. They will benefit from the decline in the dollar, as the value of their profits generated abroad increases, and from the continuing relative superior growth internationally compared to the US. Smaller companies tend to generate most of their business at home. Recently, for example, UPS reported that, in contrast to its slowing domestic business, its international business was strong. MasterCard said an increase in international transactions helped boost its Q1 revenues 24% and profit nearly 70%. Starbucks Q2 profits jumped 18% on a 20% increase in sales as it opened 560 new stores globally.

Our Bigger Caps

In our bigger cap holdings, we just added to sub-prime lender *CompuCredit* after the share price declined on disappointing Q1 results. The company was expected to have a weaker Q1, but the loss, though slight, surprised analysts. However, the underlying metrics all looked solid and the company did not alter its guidance for improving results going forward. In fact, though the stock fell about 14% on the news, one of the better sell-side analysts raised his outlook for '08 profitability. CompuCredit is a high quality, niche, financial services company with experienced management and a high growth rate, which trades at only 7x next year's earnings.

Our *Lowe's* and *Abercrombie & Fitch* holdings are both attractively priced retailers with high returns on capital, effective cost management programs and, despite a weak domestic retail environment, both have significant growth opportunities in North America and globally.

Last month we added a new bigger cap holding, *First Marblehead Corp*. (FMD), a student lender with a superb track record. When Sallie Mae, the leading lender in the area, announced in April it was to be acquired in a private equity deal which included two of First Marblehead's largest customers, Bank of America and JPMorgan Chase, FMD declined 22% that day when we began purchasing. All three companies have said that Sallie Mae was merely an equity investment for the banks and that it's business as usual. Chase is actually under contract with First Marblehead through 2010. FMD enjoys some competitive advantages, including a proprietary 20 year database of underwriting and loan performance history, which allows it to better and more cheaply access the securitization market. For a company with a competitive edge, a high return on capital and a growth rate in excess of 20%, but trading at only 9x next 12 months' earnings, it is a bargain indeed.

Petrolifera Petroleum was merely a micro-cap a year and a half ago when it came public, but now sports a market cap of around $1 billion. The company has moved production up from 2,000 barrels per day to an expected 21,000 by year's end, good enough upside potential. But, for a bonus, the company has approximately 7 million acres of prospective land, two additional properties having been added in Argentina and one in Colombia. The company expects to begin drilling on its 5 million acres in Peru early in '08 which could be extremely exciting.

Our Short Sales

Our last quarterly letter maintained that, in '06, while our shorts did not materially adversely affect our performance, they did somewhat diminish the overall gains from our longs. We are having a similar experience year to date. However, we remain confident that we can add value through shorting over the long term, as, since inception of our firm, our long/short portfolios have outperformed our long-only portfolios. But clearly it's tougher when the market continues to make new highs.

Since '03 our work has not given us a sell signal for the TSX, Dow, S&P500 or NASDAQ. We have limited our total short exposure, but not enough over the last number of months during which the S&P500 has risen 22% and the TSX by 27% from the market lows of last June.

The market still has room to ascend to our next ceiling, but it's getting closer to a peak with each record high. And, as we get closer to what we think could be a substantial market correction, we will increase our shorts to mitigate market losses.

We did close out two short positions profitably early in the year—*Avaya* and *Apple*. *Marriott* is a winner currently and seems to be breaking down now. Our three other current short positions, *Sony*, *Dillard's* and *Jack in the Box*, are in minor loss positions and trading right at ceilings (i.e., hopefully set to break down from here). Unfortunately, what was our favourite short, *Align*, jumped recently on a surprisingly profitable quarter. Align now has a US$1.5 billion market cap despite that it is merely eking out a profit. We covered at a loss because it appeared the stock was headed even higher to the next upper break point in our work. And, the fundamentals did improve much more than we anticipated as revenues were up sharply and costs down more than expected.

We need to do a better job of trading the shorts. Stocks like *Whole Foods*, *Circuit City* and others that we previously covered at a loss (i.e., they went up against us) have subsequently declined materially (i.e., we'd ultimately have gained if we had hung in longer). Covering these positions when we did was right in that they immediately rose. However, we should have re-shorted those same stocks at their next upper break points, the "ceilings" in our work, because their valuations became even more extended and their prices subsequently declined. We'll be watching Align closely in the period ahead.

Our Income Accounts

Our income accounts have enjoyed good gains so far in '07. *Magnachip Semiconductor* bonds and *Western Financial* convertible preferred shares, since sold, along with *Avcorp* and the takeout of *Entertainment One*, were the key contributors. *BlueGrouse* was acquired by *Divestco Inc.* and our convertible debentures will be rolled into convertibles of the merged company which will be substantially larger, stronger, offer more value added services with good upside in light of Divestco's shares being almost as undervalued as those of BlueGrouse. We've also added secured debentures of the following three mining companies, each of which decided to expedite the typical bankable feasibility stage, paying higher financing costs than for ordinary bank financing, but allowing them to expedite their production and capitalize on current high metals prices: *Mercator Minerals*, a copper producer in Arizona, and two Quebec-based mining companies, *First Metals*, (copper/zinc) and *Blue Note Mining* (zinc). The Mercator debentures yield just under 11% and the other two yield 13-14%, attractive income returns for secured paper and which is essentially the only debt of those companies.

Currency Hedge

For most of our Canadian and international account holders, we just reduced our hedge of US dollar assets to 75% from a fully hedged position this week near recent highs in the Canadian dollar. We still see a higher Canadian dollar over the longer term, which should benefit our US clients; however, it is currently at a level that we think does not justify the cost of a full hedge.

Tradeoff Musings

Just as with investing, life generally is full of tradeoffs. Marriage—diversification for a concentrated long-term investment. Parenthood—a good night's sleep for the pitter patter of little dividends. Conformity traded off for the thrill of being right. In the case of Abramsons—modest height for an empathy with small caps. "Going short" at Trapeze is a redundancy. But, being accustomed to having the world look down on you steels you to criticism from those with their heads in the clouds. We'll never trade our value bias for the artificial dogma consultants get paid to promulgate, even though it would be easy to pander to them. We would, however, be willing to trade all the consultants for Roger Clemens to be a starter for our Blue Jays. Or maybe for a hot dog.

Herbert Abramson and
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May 11, 2007

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