

STRATEGIC CAPITAL PARTNERS INC.

TRAPEZE ACT

Managers of investment portfolios need to be like trapeze artists—trained, disciplined, agile, proficient, well balanced and, needless to say, aware of what can happen if they misstep. Which is why we say we always look down first. Why we buy what's already low, sure, to maximize returns, but first and foremost, to minimize a potential fall—the downside risk. Value is our safety net, even if normal market fluctuations may cause temporary dips.

And, like trapeze artists, we need to perform for our audience, our clients. Gratefully, we have. The final quarter of '05, turned out to be a good one because of a stellar December. As at the end of '05, our 5-year and 3-year annualized returns (long/short composite) after fees and expenses ranked us in the top percentile of North American money managers according to the leading data base surveys. Year to date has been good too. We're happy to say it doesn't get much better for plain vanilla, value style, trapeze artists. Moreover, we are not high risk/high reward type investors. We have sought good values, diversified reasonably, been in the right place at the right time. The rewards far exceeded the risk. Indeed, they exceeded our own expectations and objectives. And, mostly from referrals, our business has grown too, so that combined assets under administration of our two related firms now exceed \$1 billion (Cdn). Beat that Ringling Brothers.

We know we must be doing something right, but honestly, we never get complacent. Sure we sometimes clown, but we know this is a serious business where it's tough to recover from a misstep. And we know sometimes the lion, or worse, the dancing bear, gets out of the cage. And we also know we are responsible for other people's hard earned money which we are tasked to conserve and grow.

Top Down

Trapeze artists enjoy a view of the entire three ring circus from their lofty perch, and similarly, we need to have a view of the world economy to make satisfactory investments. We may pride ourselves on being good bottom up stock pickers, but the investment process has to start with a top down approach. Sound macro opinions. There are no cheap buggy whip companies. Creative destruction. Blockbuster is doomed to struggle. New technologies. Remember Polaroid. Conventional telephony obsoleted. AT&T struggles.

We also need to anticipate cycle tops and bottoms. Even at single-digit price/earnings multiples, there are no cheap housing stocks if mortgage rates continue to rise making housing less affordable, causing house prices to stop rising or even to decline. Indeed, house sales are slowing.

It's an adage in our business that you sell the cyclicals when P/E ratios are low (meaning at peak earnings) and buy them when multiples are high due to depressed earnings, likely then at the inflection point of recovery. Over the past few years, it was good to avoid industries like airlines and autos, where costs are high and rising beyond control, and where excess capacity means excessive competition. Or where the local currency is excessively high allowing foreign competition to overwhelm domestic producers. China and Japan in the case of US manufacturers. Toyota overtaking Ford and GM.

And, you avoid stocks generally when interest rates are rising to the point where final demand suffers, earnings stall and fixed income instruments offer superior returns that make them an asset class to be preferred over equities.

Trapeze artists swing back and forth between asset classes and groups that offer the best relative potential return with the least risk hoping always to land on their feet poised for yet another takeoff.

Safety First

A long-standing client, relishing his recent returns, asked whether he shouldn't lock some of it up in cash. Heights obviously make him nervous. But we explained that, notwithstanding the increase, his portfolio comprises stocks, some at highs, that we think still represent excellent value and that we trim weightings as prices increase toward fair value in order to diversify and reduce risk. But, most of all, we take a broad view of our "growth portfolio mandate", and though stocks are usually best, we'll be inclined to avoid them if we are anxious about stocks. At such junctures we'd prefer cash, or high yielding bonds and income trusts, or better still, we'd hedge by increasing our short sales. We emphasize that we'll always make those allocation decisions with a view to minimizing risk. If we can find an income instrument, say, a safe high yielding corporate bond or an income trust that we think can compete with equity returns, we'll prefer the former. Thus we've been buying long dated GM bonds, (the 8-3/8% of 2033) at 70 cents on the dollar, not only for income accounts and balanced accounts, but also for margin growth accounts. A substantial positive carry while we await a potential capital gain. Costs are finally coming out, the dividend is cut in half, the dollar may decline helping competitiveness and part of GMAC is likely to be sold—at a 12% yield to maturity, these bonds offer a total interest and potential capital gain return that is attractive relative to equities. And, unlike for its stock, for its bonds to pay off, GM doesn't have to prosper, just muddle along. 700 basis points over treasuries is a pretty hefty incentive to hold GM's bonds, even if unrated.

In late 1982 when risk free 20-year Canada bonds yielded 18%, Herb put a hefty portion of "growth" accounts into long-term bonds, mostly into strip bonds and coupons, reasoning that stocks and business generally didn't work in the face of those oppressive rates and that long-term bonds would provide a better total return than any other asset class with less risk. For that radical opinion, he was labelled "Mr. Bond". Nothing to do with 007.

Of course, bonds were then ending a 50-year bear market, and with inflation at double digits, investors were sceptical that the Volcker Fed could end it. End it they did, in spades, and Mr. Greenspan then took over and presided over a 24-year bull market in bonds. Lots of liquidity was provided and created the tech mania which culminated in investors being shot from a cannon in 2000. We trapeze artists watched the whole show from aloft as we gleefully shorted Nortel and other grossly overvalued stocks. During much of that period, commodities underperformed and

capital was misallocated to redundant fibre optics and the like, so that insufficient capital was dedicated to resource exploration and development. Demand for commodities has overwhelmed supply for more than 10 years, especially with the incremental demand from China, India and the other developing countries. Now we have had record prices in oil, gas, copper, lead, zinc, aluminum, platinum and palladium. Stay tuned for gold and silver, says Herb, the best is yet to come. Mr. Bond has morphed into Mr. Gold.

It's not that we're fickle. It's that circumstances change. Often, over time, in the extreme. Money managers, like trapeze artists, need to successfully swing back and forth to perform well and get where it's safe.

Global Warning

Though we and our clients have been performing well, we're tending to be even more cautious. Making sure our value safety net is secure and even raising it a tad. There are forces at work that could weaken the global economy. Interest rates in the US are rising. "Normalizing". In Canada too. Starting soon in Japan too. Rising mortgage rates are making housing less affordable. Housing is slowing. January existing house sales were down 2.8%. Toll Brothers warns. Home equity loans in the US have been a key driver of growth in consumer spending. US household median income has fallen for the past five years. The consumer is overindebted and living beyond his means. The personal savings rate in 2005 was in negative territory for the first time since 1933. Consumer sentiment declined in February. Final demand, mainly from the consumer, drives the economy. Less spending, slower economy. Higher energy prices hurt the consumer too. GDP in Q4'05 was a mere 1.6%, and at that, supported by excessive inventories. Though retail sales for January came in stronger than expected from mild weather and redemption of Christmas gift cards, we could be due for a slowdown, perhaps even a recession in '07.

Not all statistics are equal. Employment is a very important one, being so politically charged, and ostensibly unemployment is low, the unemployment rate down to a 4½-year low of 4.7% in December. But the new jobs being created are lower paying ones, real wages aren't keeping pace and a slowdown is coming. A US slowdown means a global slowdown. Earnings growth will slow. But incoming Fed Chairman Bernanke, the new Ringleader of the circus, contrary to recent posturing before Congress, and perhaps after allowing one more increase to 5% in May, will respond by stopping rate hikes, indeed likely by cutting them back starting next year to, say, 3.5% Fed funds.

The bond market is much bigger than the stock market and because it depends on smaller incremental moves is likely a better economic forecaster than stocks. So while the Dow is over 11000 looking like a predictor of rosy times ahead, the yield curve is inverted, invariably a harbinger of a slowdown or of deflation. The 30-year US treasury yields 4.51% while the 2-year 4.67%. Now why in the world would a fixed income investor gamble when he can roll his 2-year paper as it falls due, at higher returns and keep his options open?

The Only Game in Town

But current rates, though rising, are still historically low. Rising, but historically low interest rates are likely better for stocks than for bonds. Particularly with inflation rising moderately. We think stocks are probably the only game in town. Well, by far the best game anyway. But not all stock groups are created equal. In a slow economy, safe dependables will do relatively better.

Kimberly-Clark. Procter & Gamble. *Sprint Nextel*, which we own. Consumers may buy fewer houses and autos, but they'll always buy necessities. Food, telephone, drugs, healthcare, power, heating, toilet paper. Mr. Bond, Mr. Gold, Mr. Toilet Paper.

Moreover, lower interest rates will likely mean a lower dollar which will help US competitiveness and the earnings of exporters and multinationals. GM and Ford, cutting costs, closing plants, laying off workers, shrinking capacity and downsizing, should do better. Less is more. Which is why we Abramsons opted not to be tall. The US autos and US manufacturers generally will be helped with the higher yen and euro we eventually expect. Then, too, the US is fighting a war and hasn't war always been good for stocks? It sure has been for the profits of Boeing, General Dynamics and Lockheed Martin. Higher interest rates will make debt service on the US Federal debt, already at its limit of \$8.184 trillion, more costly. So, still higher deficits. On the other hand, higher interest rates and slower consumer spending also mean higher personal savings which should benefit financial assets. And Europe and Japan both seem to have recovering economies which may pick up the US slack.

Liquidity around the world is high and has been fueling growth in stock prices and asset prices. Everywhere. Even if the cost of money rises because interest rates rise somewhat, the availability of money should stay plentiful. Good for gold and commodities generally.

It could generate more inflation. But the money has got to go somewhere. Deflation is better for bonds than stocks. It makes you poorer and incents consumers to defer spending. Bernanke hates deflation. Japan is just starting to come out of a decade of it. Moderate inflation, say 2%, is good. Okay for bonds, provides a real rate of return, better for asset prices and stocks, and allows for incomes to keep up with the cost of living. January PPI was 0.3%, but the year over year rate of 1.5% was still benign. CPI, on the other hand, rose a whopping 0.7%, but excluding food and energy only 0.2%. Hmm. Hyperinflation is bad for bonds, much better for assets and stocks, but has other risks. The latter two cases seem to us to be the most likely. Real estate is too high. For the moment, we're sticking with stocks. And on the alert for change. A dollar crisis could cause us to react. It could cause a spike in inflation as imports become dearer and interest rates need to rise to contain it and support the dollar. But, remember, a lower dollar will help US manufacturers and multinationals. And will allow the US to repay its foreign creditors with cheaper dollars. It will also allow the US trade deficit, at \$726 billion in '05, a record 5.8% of economic activity, to ameliorate.

Circus Lore

Myth One - It has been suggested that our outperformance came from a plethora of small cap stocks during a period when the small outperformed the big caps. Whereas some pundits are now suggesting that we are about to enter a period when the big caps could be superior. Fact is, we go where the value is. For the last few years it wasn't in the autos, the airlines, the telecommunications or the safe dependables. They were to be avoided. Even if we preferred small caps, there are few in these mature, capital intensive, labour intensive sectors. Big lumbering circus elephants. We wanted to be in growing, undervalued commodity type companies. Oil and gas. Golds. Best of all, many of these are in Canada so we didn't have to be concerned with US currency risk. There may be no junior autos and airlines, but there are many junior oil and gold mining stocks. And lots to choose from. The energetic little dog act. See how they jump.

Price efficiency increases with analytical coverage. So the bigger companies obviously tend to be more efficiently priced. Moreover, in these commodity groups, the market tends to pay higher multiples for the metrics of the seniors in the group. The smaller companies, by definition, have less or sometimes no analytical coverage and are often inefficiently mispriced very low. That's where we find the best value to be. The smaller companies are easier to analyze and managements are happy to interface with us so that our analysis is more exhaustive with less chance of negative surprise. If anything, when a positive surprise occurs, such as successful exploration news, it has more meaningful impact on our investment. This happened with oil stocks such as *Connacher*, *Petrolifera*, *Corridor* and *Kodiak*. And with gold stocks *Yamana*, *Iamgold*, *High River* and *Etruscan*. We have sold some outright and reduced weightings in others, but we continue to like these groups and these kinds of companies and will continue to seek out other names.

Notwithstanding, we think the industries in which the big caps operate are getting more attractive, the stocks have gotten cheaper and cost issues are being addressed. If the US dollar declines, their pricing power should improve too. So we're looking to add names in those groups. A contrarian swing with a somersault in between. We still hold *Ruby Tuesday* and *TJX Companies*. We recently bought Sprint Nextel. We are watching Wal-Mart, Berkshire Hathaway and Nike for entry points.

Myth Two - Apparently, history repeats. Therefore, commodity prices will start their inevitable decline after their 5-year or, whatever, usual cycle. However, we think we are into a unique secular process having to do with the fast growing demand from China, India and the other developing countries. And, from a continuous chronic shortage of finite commodities, much as The Club of Rome, an auspicious think tank, prematurely forecast in its 1972 book "Limits to Growth", would inevitably occur unless policies changed. Even with recent higher commodity prices, insufficient supply is coming on stream.

Moreover we believe that precious metals have much further to go when investment demand really kicks in as a flight from the US dollar, or maybe currencies generally, unfolds. Interestingly, gold recently has tended to weaken as the Asian currencies strengthened since it is denominated in the US currency.

Myth Three - Seasonal tendencies will cause gold to weaken. What causes seasonal tendencies anyway? Sure weather seasonally affects energy and agriculture. But gold? We can understand extra buying of jewellery for Christmas gifts. Indian jewellery purchases during their wedding season. But rising demand from investors and foreign central banks wanting to diversify their reserves should ignore normal seasonal tendencies. Gold and silver and many other commodities were recently temporarily overbought and in need of a normal technical correction, which is occurring. It should be short-lived, however, and these commodities should soon go to new highs. We'll be alert to add positions on the dip.

Oil and gas have done their thing on the downside and should be heading up again soon. Despite the depressing effect of one of the mildest winters on record, the outlook for natural gas prices over the next few years is excellent.

Myth Four - Phony statistics: Years ending in 5 are usually abnormally good so '05 was probably the last one for a while; if January was good so will be the rest of the year; the market is invariably poor when the AFC team wins the Superbowl; sell in May and go away; October is always a poor month. Mostly bunk. Of course, for religious reasons, we do believe in buy on Rosh Hashanah, sell on Yom Kippur.

Myth Five - The inverted yield curve doesn't mean a slowdown is inevitable or even likely. Right! It's different this time! Bernanke, in his inaugural congressional testimony suggested the yield didn't imply a slowdown, and Treasury Secretary Snow said it just meant there was good demand from foreigners for US long dated paper. A Snow job if there ever was one.

Star Performers

Since the end of Q3'05, some of our investments have performed remarkably well. In oil and gas, Corridor moved up 66%, Connacher doubled, Kodiak tripled, and Petrolifera, the star performer (held only in margin accounts), was up over 7 fold from our initial November investment.

Though these stocks have performed exceptionally, we believe all remain undervalued. Even the star performer, Petrolifera, after its remarkable 7 fold gain, is still cheap at \$11.50. The company's oil discoveries in Argentina should allow it to produce 13,000 bpd of oil by year end. At that rate of production, the stock is trading at only 3x annualized estimated cash flow and 5x earnings. The stock would be more fairly valued at \$20 (about 8x earnings) and there is still substantial potential from the company's prospective 5 million acre land position in Peru, the primary reason we were buyers of the stock in the first place. This puppy can jump through hoops.

Connacher has near term upside potential of at least 50%. The company has \$170m in cash, \$140m in Petrolifera shares, \$270m in oil sands reserves and \$600m in expected additional reserves including potential reserves which we hope to be delineated by April. Corridor still trades at a low P/E multiple on expected earnings and at a discount to its net asset value with significant blue sky potential from a possible massive gas resource at deeper levels on its property.

Pan-Ocean, our largest holding, was up only 8% over the same period. However, the company continues to deliver record production and earnings and remains on schedule to triple production by the middle of '07 with relatively low finding costs. The company is debt free and the stock trades for less than its net asset value and at half the multiple accorded to its peer group. Production increases are coming from low risk development drilling, and exploration prospects could materially increase value even further.

The whole oil and gas sector continues to look promising. Oil demand is likely to begin to overwhelm supply in the short term, especially given lack of global reserve additions. On the gas front, the situation in North America is even more extreme. While we did record the warmest January ever, this served to mask the underlying chronic natural gas supply/demand imbalance. Natural gas production actually fell over 6% in Q4'05, even with historically high gas prices and drilling activity. Oil and gas prices may stay weaker in the short term, but as we move toward the air conditioning season, the summer driving season and hurricane season, we are likely to see higher prices for these commodities.

As for our golds, Etruscan appreciated 25%, High River and *St Andrew* each rose over 50% and Yamana doubled. Yet our gold holdings still all trade at single-digit multiples based on future projected earnings per share.

Featured Acts

Other companies that have performed well since Q3'05 include: *Kingsway Financial*—still probably the cheapest property and casualty insurance company in North America; *CryptoLogic* which trades at only 11x expected earnings, ex \$5 of net working capital per share, despite delivering consistent on-line casino growth and hyper-growth from the poker craze; Ruby Tuesday, up 33% and TJX Companies, up 18% since our initial purchases in October, both consistent growers over the years, but trading at multi-year valuation lows when we purchased them.

The most recent addition to our featured lineup is Sprint Nextel, trading at about 11x forecast earnings. The company is growing quickly, is well financed and has the best industry metrics—highest revenue per user, highest gross margin, lowest churn. There are a few perceptions which have camouflaged the company's fundamental story and have restrained its stock price which should dissipate over time. Sprint should trade toward its fair value at 19x earnings and we expect earnings to grow strongly, especially once the cable company partnerships (offering cell, wireline, cable and high speed services on one platform) begin to kick in later in '06.

Our income accounts had low single-digit returns last year primarily restrained from the decline in three income trusts. Two of them, *Specialty Foods* and *Entertainment One*, remain favourites with tremendous upside potential. Specialty Foods is profitable, has raised prices, added new products and grown its volumes. We expect a payout resumption later in '06 and believe the company has an earnings yield over 25% at current prices, but is currently retaining profits. Entertainment One has a commanding share in Canada with a 95% market share in CD and DVD distribution and owns Koch, a content provider whose performance has exceeded expectations. The poor releases by the studios during '05 and the bankruptcy of two customers and a competitor contributed to lowered distributions (\$.90 from \$1.30). Even at the \$.90 level, the company is now yielding 20%. A capital gain in each of these trusts is likely.

The overall current yield on our income portfolios is about 10%. The income trusts alone have a current yield of over 11%, despite no current contribution from Specialty Foods. We anticipate capital gains from all of our trusts and collect 11% while we wait. Much like our GM bonds. Our *fixed* income holdings (bonds/debentures) have an aggregate yield-to-maturity of over 9% without any potential contribution from conversion privileges from the half of our fixed income holdings that are convertibles. One such convertible is *Bluegrouse*, whose 3-year 10% convertible debentures were bought in late November. Bluegrouse earnings cover their interest obligations many times over and are growing rapidly. The underlying equity was trading at \$1.20 when we acquired the debt, which is convertible at \$1.40. The stock price has since run to \$2.70, thereby virtually doubling the value of our debenture. At only 4x forecast earnings, the stock remains extremely cheap with much more upside potential.

Changes Are Coming

We need to anticipate change. The direction of interest rates. The level of earnings. The prices of commodities. Employment statistics. Consumer sentiment. Current account deficits. Budget deficits. Tax changes. Medicare reform. Social Security reform. Currency fluctuations. The war on terror. Changes can happen in many of these areas. Often, they need to. And we need to be nimble to take advantage of them.

Truth is there are many macro factors at work where unpredictable extraneous events or policy changes can alter outcomes. But, mainly, it's about values—buy low, sell high. And buying low is the more important of the two. Minimize risk. Trapeze artists always look down first. For obvious reasons. So do we.

Happily, changes are also happening in our firm. At the end of April, we are moving to larger premises as we are taking the 18th floor of The Weston Building at 22 St. Clair Avenue East in Toronto. Our growth requires more space. A Big Top.

It has also been suggested that the name “Strategic” is too generic and there are too many organizations of various kinds that use the same name. Wanting a name that is distinctive, after consulting marketing experts, we have chosen “Trapeze Asset Management Inc.” as the new name for Strategic Advisors Corp. and “Trapeze Capital Corp.” as the new name of Strategic Capital Partners Inc., effective around the time of the move. The name is unusual, but we think it's memorable and appropriate for us. Trapeze artists are the most proficient, the ultimate circus act. Everyone looks up to the trapeze artists. Something to aspire to, especially if you're short. The name connotes some risk. Correct, we're always cognizant of risk and we try to manage it. But, in any event, “value is our safety net.” Cute.

Besides, “Barnum, Bailey, Pierce, Fenner & Smith” was too staid and “Hedge du Soleil” was taken.

Herbert Abramson and
Randall Abramson, CFA

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