



TRAPEZA

We misspoke. In our last quarterly letter, we said we would cease justifying our new name. Yes, it sounds acrobatic. Circus like. Frivolous. Not conservative enough for serious money managers. Yes, we've applied some clever creative slogans to help rationalize the name: "Higher Perspectives"; "Value Is Our Safety Net"; "Above The Crowd". But, surely, our methodology and performance results should allow us to stop the self-conscious defence.

Then, the bombshell, when Chrisa Konstantinidis, one of our executive assistants, revealed that the name for "bank", in Greek, is "trapeza". Eureka. Sure, it may be Greek, especially to us, but nonetheless a financial connection. Subliminally, we must have known it all along.

Banks are great businesses. Take in money on a short-term basis for low rates or no rates. Charge fees for everything and put out the deposits at higher rates for loans to some of those same depositors and at especially high rates on credit card balances. It's all about the spread. That's what Herb complains about as we grow older. The spread.

Banking today is a little tougher; as the economy slows and the yield curve flattens, the spreads narrow. Banks can't make enough margin on their loans. Moreover, that usually coincides with a time of less loan demand and when defaults tend to increase.

So then the banks, especially the publicly traded ones, tend to take on more risk. Gotta get that per share earnings growth. The stock options depend on it. Then there are sub-prime loans. Houses are safe. Right. How about foreign country loans? Sovereign credits don't default. Right. Let's use interest rate swap derivatives to hedge risk. We'll be protected. Right. So long as the counterparty survives.

We like that we're not a real trapeza—nor a mutual fund—nor a hedge fund—nor specialized—i.e, limited to one sector, as in the case of, say, a gold fund, or an energy fund or a foreign country fund or an indexed fund. Rather, we are a promiscuous, "go where we're treated the best" money manager that, depending on our client's mandate, can go into any asset class, to any extent, at any time, for any while. And we can even go short to protect our clients if we hate the market or a particular stock or group, or keep cash if our minds are momentarily blank. In short, we can do whatever our individual clients would do, acting rationally and sensibly, with the edge that we have some sophisticated tools to help us make decisions, and we devote our full time to doing this on their behalves, professionally.

In some sense we are like a bank. Our clients' assets are securely custodied with TD Waterhouse, a subsidiary of a bank. Clients often ask when they should send us more money if they have cash available? When can we put it to work? Well, as with a bank, cash at Trapeze earns interest, currently at a 3.5% annualized rate, likely more than they could get on their bank accounts. We put client funds to work when the opportunity exists, at the most propitious time, and weight the holdings relative to the new total size of the account, so a cash addition to the account would require increasing the holdings to conform to our "model", but only in those securities "on buy" at that time. If they are not "on buy", we'll wait until they correct down to the buy level we anticipate.

And if a client requires funds, regularly or for a special need, it can generally be expedited and sourced from the account in the manner most efficacious for the client—cash on hand, realizing capital losses, reducing weightings, temporary margin, and the like. More thoughtfully than an ordinary withdrawal from an ordinary trapeza.

Banks are motivated to make as little as they can for their customers, paying as little as they must to attract deposits, and putting it to work at the highest rates they think they can safely achieve. And, of course, they are highly leveraged relative to their capital bases to offset the narrow spreads they typically earn. We, on the other hand, are motivated to make as much as we can for our customers, as safely as we can, on a generally unleveraged basis. Our interests coincide with our customers. If they earn more and their accounts grow, so do we.

Yellow Light

Even though we think it's always a time to be cautious, we do have some particular concerns now. We continue to believe the economy is slowing even though some of the macro reports might indicate otherwise. Statistics can be deceptive, especially when they're affected by weather or by the inclusion of an extra day in any statistical period, or by a seasonal adjustment, and usually subject to subsequent revision.

We continue to witness a housing slowdown. US housing starts for January plunged 14.3%, their slowest pace in 9 years. February could be worse in light of the extreme weather. House prices have fallen in many markets as inventories have risen. And house prices are still high relative to rents and affordability.

The low end of the market, the sub-prime mortgage market, is really coming apart, because many of the borrowers are marginal. HSBC Holdings PLC, one of the world's largest banks, is hiking its total bad loan provision by 20% because of defaults by sub-prime borrowers in the US. The absence of home equity appreciation is reducing refinancing options, they said. Some experts think prices are set to fall another 2% in '07. Fannie Mae's chief executive recently said, "In none of the top 10 US markets can the average wage earner afford the average home." New Century Financial, the second largest sub-prime mortgage lender in the US, announced it also is restating '06 earnings because it hadn't provided adequately for defaults, and its stock promptly dropped 30%. Giant home builder, Toll Brothers, continues to warn that its revenues will fall significantly.

What does this mean for the overall market and for us? Well, clearly the US sub-prime market is seeing recession-level home loan defaults. And, while housing starts have already dropped by almost 40% since their peak in January '06, just to get to the average of the previous seven cycles since 1959, we still have more to go. Moreover, each time housing starts have fallen more than 25% from their most recent peak, a recession has almost always followed.

And doesn't it make perfect sense? A significant amount of employment growth has come from home building. No more. A significant amount of consumer demand has come from US homeowners who could get cheap, tax deductible equity mortgages on their ever appreciating houses. No more. Banks, such as HSBC, were happy to lend to housebuyers knowing that their equity was rising and therefore default was not an issue. No more. Securitization of sub-prime and even of standard mortgages, which got inordinately high credit ratings and were therefore highly desirable to banks and other lending institutions, kept mortgage availability easy. No more.

Worst of all, US consumers have most of their net worth tied up in their principal asset, their house, not the stock market. And, as they start to feel poorer, it will restrain their spending behaviour.

Retailers generally have been feeling the pinch, including Home Depot, Costco, Circuit City and others. And, in Canada, Loblaws and Canadian Tire too. Nor has the weather helped. Freight transporters, like FedEx and UPS, good barometers of economic activity, have warned too. The automakers continue to suffer. Ford is reeling and continues with layoffs and the rationalization of its business. GM too, though its stock has been improving as it seemingly muddles through. But, now Chrysler, which was out-performing both, has joined, with 2,000 layoffs in Canada and 8,000 in the US. All three are looking to merge with someone, anyone, or to collaborate to cut costs and improve market share. All have turnaround plans. Oh, and by the way, while '06 capped GM's seventh straight year of decreasing US sales and Ford's sixth, Toyota will post its eleventh consecutive annual gain and may overtake GM as the world's largest automaker this year.

Eastman Kodak also said it would cut 3,000 more jobs as it continues its transformation into a company based on digital imaging. Which has Rochester reeling and Herb worried since he still carries the pictures of the grandkids in his wallet.

New orders are down and January durable goods fell 7.8%, the largest drop on record. And the yield curve remains inverted with 10 year bonds yielding less than 90 day T-bills, a market statement that there are risks to the downside, maybe of a recession, and that the market is betting that the Fed will likely ease. In fact, according to John Mauldin's latest market letter, a recent Fed study indicates that, based on the yield curve and the absolute level of Fed funds, there is a 51.9% chance of a recession. And retired Fed Chairman, Alan Greenspan, just warned the economy could slip into a recession later this year.

Profit Pressure

Profit margins, which for several years have been at record levels, are now under pressure. And, similarly, the growth of S&P500 earnings which for the past few years has been at double-digit rates is now expected to slow to 4.6% in Q1 '07. The proportion of US companies cutting their profit forecasts has reached a 5-year high. The number of S&P500 companies that have lowered their outlook for Q1 is more than 4 times those raising it, and the ratio of negative to positive guidance is the highest since the recessionary 2001 third quarter.

There is clearly a loss of economic momentum. Yet, the Dow made record highs just days ago. And, as it did so, we believed risks of a correction had increased. So did company insiders who have recently turned sellers. Markets everywhere have been strong—until now. The Chinese stock market just dropped 9% in one day, the biggest drop in 10 years. And the Dow followed with a 416 point plunge, as did markets everywhere.

Markets were due for a setback. Margin debt is at the highest levels in years. The Dow has gone up now for 4 years without a 10% correction, the second longest span on record. Even housing stocks went up in January as the shorts in them were squeezed. Volatility is unusually low. Investment advisors' sentiment, at 52%, was also moderately bearish for the market. For the first time since 2000, all the analysts recently surveyed by Barron's were unanimous that the S&P500 would be up at least 10% in '07. As a result, investors have become complacent. They have forgotten pain and fear. They need to meet our dentist.

Clearly a time to be cautious.

Liquidity Driven

What has been driving the market has been liquidity and low interest rates and a belief that both will continue. A belief in moderate growth and contained inflation. The bulls believe that, despite lower earnings growth, stocks will go higher because PE ratios will expand if interest rates stay low. And stocks as an asset class are still preferable to real estate and to bonds. In fact, because the earnings yield on the S&P500 is so favourable relative to the 10 year treasury yield, it is conducive to all the M & A and private equity activity that is buying companies in leveraged buyouts and to companies issuing debt to buy back their stocks to create shareholder value. Some are suggesting, as a result, that what we have is a shortage of assets and that the abundance of liquidity will continue to drive up their values. What Deutsche Bank refers to as "this crazy supply/demand imbalance". It estimates \$1.6 trillion came out of the stock market in '06, but new issues only replenished \$146 billion. But with the increase in leverage, the world is taking on risk at a fast rate. All this liquidity could drive a guy to drink.

But unlike commodities, whose supply may indeed be limited, even in some cases, finite, if push comes to shove, companies can issue an unlimited amount of new paper. In an economic downturn push often comes to shove.

As for interest rates, while we don't think the Fed will raise rates in '07, indeed Mr. Bernanke's recent congressional testimony is suggestive of that. However, interest rates could spike from some exogenous event, say, a credit crunch from cascading sub-prime defaults and the downgrading of asset backed pools; or the diminution of liquidity if the hedge fund carry trade (borrowing cheap money in Japan or Switzerland and lending at higher rates in the US or Australia, for example) starts to unwind; or the US dollar drops and foreign holders, especially foreign central banks with massive US dollar holdings in their exchange reserves, start to panic, which would make US treasuries less attractive and require higher interest rates to support them; or inflation picks up from labour demands, a rising minimum wage, or a commodity shock, especially from oil and gas (both of which we think are poised to break out higher); or the budget deficit balloons as tax receipts drop with the economy and spending goes up with the war.

And, the US monthly trade deficit was unexpectedly higher, and a record \$764 billion for the year. More dollars in the hands of the Chinese, the Japanese and other exporters to the US. Yet the US TICS Data, reflecting the flow of funds into and from the US was a negative outflow of \$11 billion compared to an inflow of \$74.9 billion in the previous month.

Correction

When everyone is complacent we get nervous. We always say that, in markets, don't anticipate the improbable, anticipate the impossible. Particularly when so many hold so many unwanted dollars; when the world depends on liquidity, already at record levels; when the US national debt is nearly \$9 trillion and growing \$1.24 billion per day; when interest swaps and derivatives total in the trillions of dollars, probably more than 3 times US GDP; when a couple of trillion dollars of ARMs will need to be set at fixed rates over the next year or so (4% of ARMs are already more than 60 days delinquent); when 30 year bonds which once made up over 30% of US national debt are now less than 5% and short-term paper is now over 50%; when the US "depends on the kindness of others", such as Japan, which may not be so kind if the Yen starts to appreciate.

So we continue to be cautious, but despite the economic slowdown and the recent market decline, because the markets remain "on buy" in our work, we don't think the market correction will be prolonged or severe. Based on anticipated earnings and interest rates, the US and Canadian markets remain undervalued. We are therefore compelled to stay fully invested though we continue to be highly selective and to focus on companies that are cheap, growing and can seemingly withstand a downturn or have already declined sufficiently to discount the impact of the downturn.

For example: *Pinnacle Airlines*, which has doubled since we began buying it in November, still sells at a single-digit P/E multiple; *Kingsway Financial*, up over 67% from our entry point 3 years ago still sells at a single-digit P/E, at a slight premium over book value and is probably the most inexpensive property and casualty insurer in North

America; *UnitedHealth Group* trades 20% below our estimate of Fair Market Value (FMV) which is growing rapidly; *Lowe's Cos.*, though up over 15% from our initial purchase 6 months ago, still sells for a 25% discount to its growing FMV. In the case of *Lowe's*, though we are clearly concerned about the housing slowdown, it is differentiated from housing stocks. First, its cost structure allows it to lower costs in the event of a sales downturn. Second, its growth continues through increased store openings and significant market share gains. Finally, it is our belief that the home renovation business should do reasonably well in a period where declining housing sales cause a shift to home renovation.

Recent purchases include *CompuCredit* and *Allen-Vanguard*. Both fall into our "favourite buy" category—fast growing companies with high returns on capital at less than 7x earnings. Though it is a sub-prime lender, and has been painted with the same brush as the whole sub-prime group, *CompuCredit's* business is not mortgages. It operates three separate divisions: principally offering credit cards to customers with low or no credit ratings (and its credit underwriting abilities are among the best); payday lending; and auto lending. Sure, a severe recession could impact the company's earnings from increased delinquencies, but, the company, as an offset, would likely then have a whole new series of potential customers and acquisition opportunities. Over the last few years, *CompuCredit* has grown its FMV nearly 30% per annum, yet, after deducting the company's \$100 million net cash balance, it trades for just under 7x '08 earnings and it carries over \$600 million in excess liquidity.

Allen-Vanguard is an Ottawa-based defense company whose key products are Electronic Counter-Measures devices (ECMs)—software that is combined with a partner's hardware for jamming detonation of bombs. We just participated in a secondary issue at \$5, the proceeds of which will likely be used for acquisitions. In the meantime, the company, through its key partner, Lockheed Martin, should win a large portion of the \$1.4 billion of contracts being let this year by the US Department of Defense. Should Lockheed merely win just over 10% of that figure (which we believe is low), we still expect *Allen-Vanguard's* earnings to be over \$.60 per share in '08. Furthermore, President Bush has requested an incremental \$2.4 billion to be spent on ECMs this year and \$4 billion for '08.

Golden Opportunity

We continue to favour the golds and still believe that commodities generally should remain strong, again, principally because of the phenomenal demand from the emerging countries. Indeed, copper, a good barometer of the phenomenon seems to be through going down as the Chinese are replenishing stocks. Nickel, silver, platinum and palladium are all trending higher.

Jewelery demand for gold in '06 was strong, but could weaken going forward with the weaker consumer demand we envision. But investor demand should stay strong, especially if interest rates stay low, if liquidity continues to stay high, if Asian central banks which have low holdings in their foreign exchange reserves increase their holdings, if the dollar continues to decline as we anticipate, and if the stock markets decline markedly and there is a move towards safe havens.

The two biggest producers, Barrick and Newmont, while reporting slightly better than anticipated earnings, both cut their production guidance for '07.

We believe that gold, currently at \$670, should again surpass \$700 per ounce in '07. A number of analysts now share this view too, including the Citigroup metals analysts who recently urged the largest gold company, Barrick Gold, to unwind or repurchase its massive \$4.3 billion hedge book, allowing it to capitalize on the expected higher prices.

We have taken some profits in *Yamana*, at the recent highs, but continue to hold *Etruscan*, *High River Gold*, *IAMGOLD* and *St Andrew Goldfields*, intending to increase our position in the latter in its recently announced attractive shareholder rights issue. All of this gives us an overweighting of about 19% in this group.

Oil and Gas

And, we continue to be oil and gas junkies. While other money managers may have departed the group, we continue to be faithful. How boring are we? Undervalued stocks, golds and oil and gas.

We continue to believe we are in a long-term bull market for oil and gas. Oil production appears to be flat, with growth stalling in places such as Mexico, Norway, Kazakhstan and Iran and at ExxonMobil, the world's biggest producer, (whose production declined 1% in Q4), with the long lead times on new production and the political problems in producing countries such as Iraq, Nigeria and Venezuela. On the other hand, inexorably rising demand from the emerging countries, such as China and India, and the increasing demand to fill strategic petroleum reserves in the US, China and other countries, will put upward pressure on prices. Natural gas may be even better, with prices also headed higher as the heating requirements go up because the recent cold weather is using up gas storage quickly. On the demand side, because of the recent price weakness, capex has declined materially, as evidenced by the reduced active rig count in Canada and the US. So, with gas supplies and production under pressure, a shortage should develop later this year causing a recovery in prices. Unlike oil, natural gas is essentially a local market, but we note, with interest, Russia's President Putin travelling throughout the Middle East apparently proposing a natural gas cartel. GASPEC?

Our oil and gas holdings also are very inexpensive. The ones operating in the coal bed methane arena, *Richards Oil & Gas*, *Storm Cat Energy* and *Stealth Ventures*, have performed poorly due to investor concern regarding the ability for these companies to profit in a low natural gas environment, despite recently improving gas prices. But all three are cheap. In the case of Richards, it has successfully discovered "dry" Ardley coals, where others have failed for nearly 20 years. Now it's a matter of assessing the flow rates from the Ardley zone into which we should have some insight in the next few weeks. Storm Cat, in which we recently purchased convertible debentures, trades well below its FMV. When the production rates and cash flow we expect over the coming months are achieved, we expect the stock to move up smartly.

Most of our oil and gas holdings took a hit in the latter part of '06 and into January as oil and gas prices declined from last year's highs. Many of these companies have since rebounded considerably on specific company news.

Connacher Oil and Gas, which trades at a 35% discount to its fast growing FMV, announced drill results and updated its progress in its oil sands project which shows good promise for adding incremental value in the short term.

Kodiak Oil & Gas released the results of its first significant well (the second is expected any day) in Wyoming's Vermillion Basin where it is the second largest land holder. The results were above expectations and are beginning to validate the company's prospects in investors' minds. Good results from the next well could drive the current share price higher. Superb drilling results from its neighbour, Questar, have recently helped too.

Petrolifera Petroleum continues to have success in Argentina, announcing an aggressive 50 well drill program for '07. The company also is getting closer to drilling its highly prospective 5 million acres in Peru. At less than 6x '07 earnings, and growing rapidly, Petrolifera remains a bargain.

Rally Energy recently surprised the market with much higher reserves. The shares moved up and the Company raised \$50 million at \$5 to support its ongoing development. Yet Rally still trades at a 25% discount to its FMV and only 10x '08 earnings, cheap, given its prospect of doubling production in Egypt by the end of '08 and its potential from its upcoming gas drilling program in Pakistan.

Corridor Resources just announced that, in the course of drilling to its potentially 5 TCF Dawson Settlement deep zone, for which it failed to get deep enough on this try, it may have discovered a whole new fractured zone which is highly gas charged and could be important. Testing in the next few weeks should tell us the initial flow rates. At 6x '08 cash flow and 4x '09 from the Hiram Brook (the upper zone) wells alone, Corridor continues to be very promising. And we're still keeping our fingers crossed for a Dawson Settlement bonanza.

Pacific Energy Resources, our most recent oil purchase, has performed very well. The company now owns the offshore California platform and reserves it spent years trying to acquire. And, prospects for it finding gas in Wyoming, where the company is currently drilling, look quite promising. Based on the offshore assets alone, we believe the company is still great value trading at only 5x '08 earnings.

Hedging

Our shorts did not materially adversely affect our performance in '06, but did somewhat diminish what was achieved on the gains from our longs. The good news is that in each of the last 3 years we have reduced the extent of the diminution. We are confident that over the long term we can add value through shorting. We have shown that to be the case as since inception our long/short portfolios have outperformed our long-only portfolios.

Shorts continue to be an important component of our portfolios in order to hedge the longs in the event of a sudden unexpected market decline, and to protect the portfolios from regular anticipated market declines when the markets, in our work, are “on sell”. Interestingly, our work has not given us a sell signal for the TSX, Dow, S&P500 or NASDAQ since '03. For that reason alone, we’ve limited our total short exposure to 20% (and less at times) of the portfolio during that period. But, if we do foresee a serious market correction, we will increase our shorts to mitigate market losses. Naturally, we hope to reverse, cover the shorts and increase our longs, whenever we think the market has bottomed. Again, over the last 4 years, the markets haven’t had the usually sufficient correction to allow us to rapidly book short profits.

As value investors, the same criteria for allowing us to recognize undervalued stocks, should allow us to recognize overvalued ones. And, we have. Unfortunately, we have not done a good job recently of trading the shorts. In the last couple of years, virtually all of the stocks that we covered at a loss (i.e., they went up against us) subsequently declined (i.e., we’d ultimately have gained if we had hung in longer). Actually, we didn’t necessarily make trading errors by covering these positions when we did, as in most cases, they immediately went higher. However, we should have revisited these positions at upper break points, “ceilings” in our work, and re-shortened these same, now even more overvalued, companies. Randall refers to these short trading errors as Groundhog Day. And, as annoying as it is to continue making the same trading mistakes, we know we are learning from them and getting better.

Every so often we’ll make an outright mistake with a short too, as we sometimes invariably do with the longs. Redback, for example, which was acquired by Ericsson, despite having no earnings, and struggling for profitability for some time, with products inferior to those of its competitors. But, nonetheless, Ericsson paid \$2.1 billion to buy it. Wynn Resorts, the casino operator, was also a clunker. We did not anticipate they’d make something from nothing selling excess land in Macau for hundreds of millions. The valuations of all casino stocks, including Wynn, are now into the stratosphere, driven by excellent Las Vegas results, Macau surpassing Vegas in revenues, and investors trading casinos like REITs, an already heightened market, perhaps a bubble in the making.

Our favourite current short is *Align Technology*. It has an excellent orthodontic product—but only one. Which Randall has used and, now, has a perfect smile, but only when we’re performing. The company sells at an unsustainable valuation. It still has no profits yet Align has a market capitalization exceeding \$1 billion and trades at 5x its sales. Other shorts include: *Avaya*, a telecom equipment stock with single-digit sales growth but an unjustifiable 20x multiple, subject to lots of competition; *Dillard’s*, a department store chain with mediocre locations, anemic returns on capital and poor growth rates selling at a 30% premium to its FMV; and restaurant chains *Wendy’s* and *Jack in the Box* both of which, at over 20x expected earnings, and only 5% annual top line growth, sell at prices which have been propped up by highly promoted cost reduction plans, and, in our work, are overvalued 25% and 40%, respectively.

Income Accounts

Our income accounts have rebounded nicely so far in '07 led by the strong performance of Canadian REITs, the uptick in *Magnachip Semiconductor* bonds which we have since sold, the increase in our *Avcorp* and *Western Financial* convertible preferred shares, also just sold, and the acquisition of *Entertainment One*, closing in March. The last two years were the only years at Trapeze where our Income Accounts did not achieve double-digit returns (although our return objectives are more conservative). And the income trusts that adversely affected our income results over the last couple of years will, thankfully, no longer be a factor.

True Patriot Love

As discussed in our last letter, we continue to be happy investing in Canada in light of the prospects for the Canadian economy and its currency. It was often said that when the US caught the flu, Canada caught pneumonia. After all, Canadian exports to the US represent one-third of Canadian GDP. Despite the US slowdown, there are signs that an inventory correction in Canada has taken place and that Canada seems to be coping with the adjustment in the US housing and automotive sectors.

Wholesale sales in December were up 2.7% over November, far above forecast, with, believe it or not, auto sales leading the way. Last month's labour report shocked the market with 88,900 new jobs, 6 times what was expected. Consumer spending and financing have boosted housing construction and retail sales. Factory shipments jumped 1.7% in December and Canada had a 9-month high in its trade surplus. The trade surplus for Q4 is expected to improve which should cause GDP to be revised upwards. Remember too, mortgage interest in Canada is not tax deductible, so housing didn't suffer the extremes and there aren't ARMs to get rolled into fixed rate mortgages.

Best of all, commodity prices are staying strong. Canada is the biggest oil exporter to the US and the economy of Alberta is on fire with oil sands development. Canada is the world's third largest gas producer (we hope Corridor will make it the first someday), providing the US with 17% of its total natural gas consumption, accordingly heating half of its homes. If oil and gas prices improve, so should Canada and its loonie. If the Canadian dollar gets firmer, as we expect, Canadian inflation should be contained from cheaper import prices, and Canadians will be wealthier as its dollar buys more foreign goods and services, including Herb's monthly maintenance fees at his Florida condo.

So while we continue to invest in the US, especially in bigger cap names, investing in Canadian stocks is for us, currently, a somewhat safer proposition, particularly for the commodity producers, whose prospects seem so bullish. Foreign investors who want exposure to those kinds of companies, to the improving Canadian economic prospects and to a rising currency, may jump in too. As they do, Canadian investments generally should benefit.

Market corrections offer up opportunities. Especially to value investors waiting for those “buy points”. If there are attractive values, whether in Canada or the US; big, medium or small cap; beaten up sub-prime lenders; temporarily depressed retailers; prospective oil and gas producers; growing gold producers; or whatever, wherever; you know we’ll be ready to pounce. You can take that to the trapeza.

Herbert Abramson and
Randall Abramson, CFA
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