



THE WRITING IS ON THE WALL

Back in 1981-1982, when inflation was running at double digits, with mortgage rates in Canada at 15%, the prime rate reaching 22% and 20-year risk free Government of Canada bonds yielding 18%, Herb was given the nickname "Mr. Bond". Herb reckoned long-term treasuries were by far the best asset class, that business didn't work at those oppressive rates, that stocks and gold couldn't compete and that inflation and interest rates would necessarily peak from the effects of then Fed Chairman Paul Volcker's monetary tightening. Buyers of risk free 20-year bonds suffered a significant capital loss in a brief violent period. But, because psychology tends to extrapolate that trends will continue from their recent behaviour, many could not accept that inflation and interest rates were topping. Yet, all you had to do was buy a 20-year 18% bond and go lie on a beach.

James Lymburner, the consulting economist at Herb's then firm, also believed that the change was inevitable, that, as he said it, "The writing is on the wall, but not everyone can read it."

The writing is on the wall today. For stocks, as it was for bonds in 1982. Good stocks are like perpetual bonds, even better, because their earnings, the theoretical coupon, grows. Stocks are huge bargains, relative to all other asset classes, and are screaming to be accumulated. Large and small cap U.S. stocks now trade at 13x forward earnings for an almost 8% earnings yield, while 10 year treasuries yield just 4%, making equities the best bargain in more than 60 years. And cheap compared to their book values too. And with excellent corporate balance sheets. Sure, there might be some additional adverse fluctuations as fearful investors continue to capitulate but where else can you invest your money as safely today and go lie on a beach? Though real estate in Miami, down 27% year-over-year, is catching up fast. And it's already at the beach.

Wall of Worry

If, as it's said, bull markets climb a wall of worry, this bull should kick in soon. And we think it will. There is no shortage of concerns for investors. Record high oil prices and food prices. Declining house prices in the U.S., down over 15% year-over-year. Consumer spending in decline. A credit crunch, with big cap financials such as Fannie Mae and Freddie Mac, which together hold \$5.3 trillion or half of all U.S. mortgages, in meltdown mode and requiring a government bailout. A run on California bank, IndyMac, forcing regulators to shut it down, the third largest bank failure in U.S. history. A potential for rising government budget deficits from a decline in tax receipts and higher expenditures to support the economy and the military. Fear that a new Democratic administration in January will raise taxes and further restrain the economy. Potential for a serious recession.

Rising unemployment. GM struggling to avoid bankruptcy. A declining dollar. Fear of inflation. Fear of deflation. Fear of the unknown. Fear of the sky falling. The mother of all walls of worry. Right up there, with that Great One in China.

Markets are ugly. The blue chip Dow Jones Industrial Average was down 10.2% in June, the largest point drop ever for the month. Huge volatility for high quality stocks. From fear.

It's axiomatic that fear creates opportunity—bargains. Bargains are what value investors covet. So our portfolios are chockablock full of bargains. But just as value investors generally have suffered inordinately in this decline (compared to momentum investors), so have we. Although we believe our stocks will recover smartly from here, we regret the angst it has caused our clients, and therefore, us, since the decline from the highs of 2007.

The extent of the declines has been as ugly as markets ever get. The Value Line Index (1700 U.S. stocks equal-weighted) fell 27% from its '07 highs. The TSX Venture Exchange (small cap Canada) is down 35% from its '07 peak, most of the damage occurring in the last 9 months. The declines of both the Value Line and the TSX Venture wiped out all gains in those indexes dating back 3 years. This is particularly unbelievable for the TSX Venture, given the very high proportion of commodity stocks with commodity prices near all-time highs. Our performance has been worse. We're relatively concentrated and some of our holdings have corrected severely even while their underlying fair market values have grown.

We are currently fully invested, and where we can, then some, using some leverage. We are currently not short anything. In the same mode as we were generally following the 9/11 catastrophe and after March 2003 when we believed markets were bottoming. When investors are panicking and selling indiscriminately, when funds are reluctantly forced to liquidate from redemptions and when the news is the worst, the fear palpable, and the values so compelling is the time to be buying. All of the key indicators that are prevalent at market bottoms are now in place.

What Does Trapeze Know About The Writing On Walls?

Why should you listen to us now when we say the writing is on the wall? Well, first, history is on our side. After similar declines in house prices and increases in unemployment, the market has typically been higher, over 20%, one year later. There may be a little more decline, a little more pain, but the worst is likely behind us. Value will out. Tincture of time. Buy low and go lie on a beach.

Secondly, history also shows that even from a time standpoint both the bear and the economic downturn are getting into late innings. The markets topped out almost a year ago. But bear markets are relatively short-lived compared to bulls. The average duration of bear markets over the last 50 years has been 8 months. The market is a leading economic indicator—it discounts future activity. According to Ned Davis Research, on average, bear markets bottom 4½ months before recessions end and several months before earnings trough. Markets have an upward bias from growth and inflation. Economies too. Especially when interest rates are benign.

While downturns are painful, they are a healing process. Excesses are corrected. Inventories are trimmed (they are already low). Balance sheets are strengthened. The savings rate improves—firepower for renewed consumer spending. Mortgage defaults decline. Housing becomes more affordable. Money becomes more plentiful. Cost-cutting makes productivity and competitiveness improve. Therefore, earnings improve too. The yield curve turns positive, a bonus for banks. Trade deficits improve. Mergers, buybacks, and similar activities are accretive to shareholder values when shares and corporate debt are bargains. The weak disappear and the strong get stronger. Corporate Darwinism.

Obviously, stocks need growing earnings. That might, in many cases, depend on an improving economy. But they also need a low interest rate backdrop. And we think, despite headline inflation numbers, interest rates are not likely to go much higher, if at all, anytime soon. Though the Fed talks inflation and the dollar, they will be subordinate to its concerns about unemployment and the financial sector debacle. Moreover, though admittedly U.S. headline CPI for June was high at 1.1%, the core rate ex-oil and food was only 0.3%, the widest disparity between CPI and core CPI rates since 2005 and 1980. Inflationary pressures are limited outside of the raw materials sector. Hard to imagine inflation being a concern when housing, which represents some 40% of CPI, is down 15% year-over-year, and in many areas worse, with delinquencies and foreclosures on the rise. And average hourly earnings rising modestly as unemployment rises and GDP remains weak. And the consumer, cutting back his spending as his principal asset, his house, declines, is cautiously saving more. Retailers, such as Costco, are having difficulty passing through higher costs. As we write this, commodity prices, including energy, corn, livestock, sugar, coffee and gold are all weaker. But, in any event, even if inflation were to pick up, stocks would be far better than cash or bonds.

U.S. markets, indeed all U.S. assets, could benefit if the dollar stabilizes. It may, notwithstanding the U.S. credit markets and general economy, if only because foreign markets and economies are also suffering, especially in Europe.

Thirdly, there is evidence that a bottom has been reached. Pessimism is rampant. Negative earnings surprises have become the norm—Google, Apple, American Express, Costco. Cash on the sidelines is a record \$8.5 trillion, over 20% of all U.S. household assets. Investors, being so risk averse, haven't even been trusting Money Market Funds as a place to park their cash, but have been buying T-bills directly. Short interest is at record highs (18.1 billion shares at the end of June) and hedge funds may have exacerbated the decline with naked short selling and the dissemination of unfounded rumours, both of which are being investigated by the SEC. Contrary indicators support a bottoming market. According to Merrill Lynch's monthly survey, institutional investors are at a record underweight stocks and overweight cash. The put/call ratio (bearish put options compared to bullish call options) is high. A record number of new lows (1,304 NYSE new lows on July 15 vs. only 19 new highs), reflecting severe pessimism. The Volatility Index recently got through a high of 30. Investment advisory services are net bearish and corporate insiders, the ultimate contrarians, have stepped up their buying relative to selling, a very bullish indicator. New issues are at 2001 lows. Notwithstanding a year-over-year annual CPI number of 5% for June, the highest since 1991, interest rates have remained low, and the Fed likely won't be

inclined to raise them so fast. In fact, money supply is rising, in the face of the ostensible inflation. It would appear the fear is "in the market".

Looking Through Walls

Interesting, that people normally afraid of heights reel irrationally at stock market highs when the outcome is the most dangerous, but are the most fearful at bottoms when it's the safest. But that's for ordinary investors. Our value philosophy derives from the philosophy of the eminent value investors. Indeed the vast fortunes of legendary value investors, such as Bernard Baruch, Warren Buffett and recently deceased John Templeton, were made by buying low and selling high. Buying low, by definition, implies buying when most others are selling and conversely, selling high is taking advantage of the excessive demand at tops.

Renowned Wall Street investor, Shelby Collum Davis, once said, "You make most of your money in bear markets. You just don't realize it at the time." John Templeton said, "The time of maximum pessimism is the best time to buy and the time of maximum optimism is the best time to sell." Buffett put it another way during the ugly bear market of the mid '70s, claiming to feel "like an oversexed guy in a harem".

Value investing is just about that. Investing, not speculating. "Buying low" for value investors doesn't just mean that the quotational price has dropped to some fraction of the high, but that the metrics of the underlying business have reached a level where the price relative to book value, net asset value, revenues, earnings and free cash generation are compelling; where returns on equity and capital are high; where the potential for growth of all of the foregoing is high; and where the balance sheets are conservative and the acumen and integrity of the management are unquestioned. Of course, all this has to compare favourably to what fair market valuations would be in normal periods and to what risk-free income investments adjusted for inflation currently yield. An investment made on the foregoing basis is likely to generate a significant potential future gain with minimal risk. Low risk, high reward.

Walls Seem Higher For Small Companies

We think the stocks in our portfolio fit the bill. Low risk and high reward. Just because the market doesn't yet appreciate our names because most are smaller cap, and have gotten cheaper still from when we bought them, doesn't mean they're riskier. It grieves us to report the depressed quotational values to you, but their potential for reward has gotten even greater and their risk is even less.

Small cap Canada (as represented by the TSX Venture Exchange) is down 23% YTD and 32% over the last 12 months, a pace which should not continue. This decline is irrelevant to the underlying value of our companies which, for the most part, have been increasing. Contrast with the carnage for big caps too, where the underlying value has been deteriorating. But, market psychology has been as ugly as it gets and investors have been dumping small cap stocks, regardless of fundamentals. According to Ned Davis Research, small caps begin to outperform large caps 4 months before recessions end. A clear opportunity to any sensible investor.

We buy pieces of businesses. Good businesses, selling cheaply. We understand them well, and we wait for them to be understood and appreciated by others, either in the market by other investors as our names gain popularity, or by acquirers who want to own all of it. Ben Graham, the Dean of value investing, said that if you buy a stock cheaply enough, if the market won't give you fair value, a real buyer will. Interestingly, over the last 10 years, of the 18 oil and gas stocks we bought and sold, 12 were taken over, either when we owned them or shortly thereafter.

We're generally in the right space, about 60% oil and gas businesses and 15% gold mining businesses. The prices of the commodities they produce are near highs, much higher than when we bought them and much higher than we're counting on for them to succeed. The energy sector, driven by the big caps, was the best performing over the past year and the first half of '08. But paradoxically, not for us. Yet. And, the energy sector, at 10x earnings is still the cheapest sector of the S&P 500.

Generally speaking, the businesses of two-thirds of the companies we hold have never been better. Cheap, but strong and growing. If only from the rise of the commodity prices. The other one-third are very cheap but not growing and are more tied to a recovery of the general economy. In the strong and growing category many, such as *Corridor Resources*, *Petrolifera Petroleum*, *Cano Petroleum*, *Sterling Resources*, and *Etruscan Resources* have very recently completed money raises (at higher prices, we might add), have solid balance sheets and all of them can grow significantly over the near future. We don't count on better markets to make them profitable for us or on higher commodity prices, though both are good. On the other hand, if we had to choose between higher oil and gas prices or a better stock market to help our energy stocks, we'd probably pick the latter since market efficiency would improve and reality would return.

Some institutions, with a view to diversifying, have been buying the commodities themselves instead of the stocks of their producers—in our view speculating, not investing. It has likely exacerbated the disconnect, with the prices of the underlying commodities such as oil, gas, gold and silver more expensive than the shares of their junior producers.

Despite lower commodity prices, our gold stocks should do well even if the economy and markets weaken. Perhaps because of that. The shortfall of gold supply to meet demand is not improving and the costs of production continue to rise. Value will out, one way or another.

St Andrew Goldfields, now with a significantly improved balance sheet and a positive production decision, should generate meaningful cash earnings commencing in 2009 and be able to exploit its exploration potential.

Our energy holdings are at outstandingly low valuations. You had better believe big cap energy, which is having trouble reinvesting its outsized earnings, is looking at cheaper and faster-growing small cap energy for investment opportunities.

As for the commodity price risk, our oil and gas companies will grow, mainly with the drill bit. And, in any event, we don't think oil and gas prices will collapse even if they temporarily correct. Supply growth from both OPEC and non-OPEC producers is anemic as new projects suffer from delays and cost overruns and maturing fields are fast declining. Oil sands cash operating costs have risen substantially over the past year. Demand continues to grow strongly in emerging economies. A quarter of fuel demand is subsidized in places such as Iran, Venezuela and China. Oil exporting countries, such as Saudi Arabia and Russia, are seeing their own demand increasing as their per capita wealth goes up.

We believe, in due course, we'll get taken out of our *Orca Exploration* holding. It has the same controlling shareholder as did *Pan-Ocean Energy*, which got sold at a significant premium and we're hoping for a repeat performance with Orca. There is talk that the Chinese are actively looking in Tanzania for opportunities to lock up resource production.

Connacher Oil and Gas could get taken out as its production of heavy oil over the next few years is set to grow materially. The newspapers report that Indian entities have been looking for heavy oil investments in Alberta recently. Connacher trades at less than one-half of the discounted net present value of its 2P reserves and less than one-third of its 3P reserves. A very attractive takeover candidate.

Canoro Resources is trading at one-half of its recently reported net asset value of \$1.70 and could be attractive to a buyer with the cash to develop its prospective Indian assets.

Corridor has received confidentiality agreements from at least 3 large, publicly traded U.S. energy companies who are looking at its huge Frederick Brook shale opportunity, a potential 22 TCF in place. And it's in New Brunswick, close to the best markets, New England and New York. A joint venture is a distinct possibility. In the meantime, Corridor is accelerating its development with funds from its recent issue (done at a price 50% higher than its current price only 30 days ago), has hedged 50% of its winter gas production at \$15 per mmcf, and is trading at less than 7x forecast exit '08 annualized cash flow. All that and trading at one-third of our fair market value. A win win.

Not only has the underlying value of most of our holdings grown, several of our key holdings have pending catalysts to add further value. For example, *Pacific Energy* should continue to generate cash to pay down debt from recently announced non-core asset sales and by regaining funds locked up in a surety bond. And, production should rise by another 50% over the next few months. The business has never been better (that's why we don't lose sleep at night) yet the stock price has never been worse (causing sleepless nights for clients). Reality will return because the fair market value is closer to \$5 per share compared to the \$1.10 share price. So the share price could rise significantly over the months ahead, fully justified by the underlying values. *Canadian Superior Energy* appears to have another gas discovery at its Bounty well offshore Trinidad with test results expected in a couple of weeks. Good test results could add 50% to the share price and heighten the anticipation of the third well to be drilled, yet the share price languishes.

The businesses of some of our other stocks are more susceptible to the slowing economy, and we buy them recognizing that, with the conviction that whenever the economy recovers these stocks will outperform. *Walgreen* just raised its dividend, and reported a 9.9% increase in revenues, despite a tougher environment. *United Technologies* raised its guidance. *Ruby Tuesday* reported lower profit, but better than expected. *Penn Gaming's* proposed takeover at \$67 fell through, and the stock is a little lower than we paid, impacted by generally slower casino markets, but it got a break-up fee of \$125 million net of tax plus \$1.25 billion in zero coupon 7 year preferred equity with which to buy back its own cheap shares (which it said it will) and grow its business. *Office Depot* disappointed, and, cheap as it is, we've elected to sell our position taking the tax loss and use the proceeds elsewhere. *CompuCredit* languishes, though we believe it is endeavouring to acquire credit card portfolios from other lenders at favourable prices, and in any event just by running off its own portfolio could realize more than twice the current share price. *Allen-Vanguard* is not affected by the economic downturn but is by lumpy contract wins. It sits at an oversold low but on any of the contract news we expect, it should move up significantly.

And The Walls Came Tumbling Down

We often wish our good, safe and growing businesses were private, not public companies. But the volatility from being public creates the opportunity for cheapness. We believe none of our companies could be acquired entirely at their current low prices. Indeed, their current cheapness is likely an impediment to their being taken out inasmuch as the premium to get to their private company values is so high. But in a market upswing those volatile stocks could have the torque to rise quickly to reasonable take-out levels. The wall cheap small caps need to climb, as it usually does, should fall quickly, like the ones in Jericho and Berlin did.

We keep reminding clients that no bell goes off at the bottom and you've got to be there when you think they're throwing them away, irrationally. Catching falling knives does cause some pain but when they ultimately transform into helium filled balloons, it's magical how the pain turns to joy.

One day soon, maybe today, the market will rally despite some bad news. Because all of the bad news will have been discounted. Because the selling will be exhausted. And the game will be on. Fed by the mountain of cash, earning zip, scrambling to get back in, and by the paucity of sellers. We note now in many of our names, the widening gaps between the bid and offerings, the diminished volumes and the scarcity of offerings—upside gaps waiting to happen. Indeed, imagine if there were a positive surprise—in respect of housing or unemployment or the dollar or inflation or commodity prices. If Osama were captured. Or McCain topped the polls. Or capital gains taxes were moderated. Or GDP strengthened. Or corporate profitability were improving which, relative to expectations, it is, as evidenced by Intel, IBM, Wells Fargo, Bank of America, Altera and even our own Ruby Tuesday and United Technologies.

Where We Erred

Interesting how for some considerable time Trapeze talked and wrote about many of the problems that are now upon us. Outsized financial derivatives. A housing bubble. Stagflation. But, hey, we were in the right places, 60% oil and gas, 18% golds. No matter the cap, we thought, because smaller caps were, after all, the cheapest by far. The good part is that we are value investors. The bad part is that we are value investors, and didn't appreciate the premium that would be paid for liquidity in a decline. Small caps of any kind were shunned. Nor could we conceive the magnitude of the declines and the volatility. Bear Stearns, Fannie Mae, Freddie Mac, Citibank, Merrill Lynch, General Motors, Ford, GE, airlines, foreign markets, you name it. Nowhere to hide except, maybe, big cap resource. As opposed to small cap resource, or small cap anything.

Our excellent SVA™ work does work, but we couldn't use it effectively. We start with fundamental analysis, so when a stock got cheap, no, very cheap and hit an SVA™ floor, we bought then, only to see it break through the floor from the unusual bear market forces at work.

The SVA™ methodology works best with stocks that have reasonable liquidity (i.e., that can be bought and sold easily) and which move up and down relatively slowly. It is obviously less useful with smaller cap stocks which have less liquidity. Small stocks can also have a propensity to move up and down quickly, so that by the time we get an SVA™ signal, the stock may have already moved too far away—down to the next floor.

Despite these factors, value investors tend to buy smaller cap stocks when they offer far higher returns than larger stocks, sometimes a multiple thereof. In fact, until recently, many U.S. large cap stocks were trading at values higher than their net asset values and were not at all attractive to us as value buyers.

Small stock investing, though, often means waiting. One has to hold the stock through the ups and downs until the desired target prices are reached, although we do often trade a part of our positions where we can. We were selling a portion of Connacher, Sterling, Canadian Superior, Cano and *High River Gold* near the highs in the last couple of months. And, we've been buying back High River Gold and Canadian Superior. We do clearly regret not selling some of our holdings as they gave us sell signals and/or hit record highs last year, especially with the potential for a market correction which could heavily impact small cap stocks in general.

Why Trapeze?

No bell goes off at bottoms. Bottoming is a process but we think our views are thoughtful and reasonable. We don't know where markets will be in a day, a week, or even a month. But we're very confident that within a year, investors who hold and buy cheap and good businesses today will be rewarded. Buy and go lie on the beach.

Our own rate of return estimates for our model portfolio, based on conservatively estimated fair market values, indicate a one-year potential return that would surpass our '07 highs from here. If we only achieved a fraction of that, from these depressed levels, it would more than make up for the pain. A very important stat—the difference between the current prices of our holdings and our appraisal of their fair market values has never been higher.

We are excited about the potential for stocks generally going forward, but really excited about our individual names. Our return estimates cited above may seem remarkable, but remember that they were more modest returns before the dramatic declines we have recently experienced. And, as we have noted, most of these companies have gotten stronger notwithstanding the price declines.

The market's appetite for stocks and for small cap stocks will return, and the increase in the price of our stocks could be quite significant. We experienced the same thing after the market declines of 1998 and 2002. And, we expect the recovery back to old highs to be rapid this time too. The values are clearly there for all to plainly see. This has merely been a period of violent but temporary fluctuations as stock prices (but not the underlying company values) have suffered.

Now is the time to be committing available cash to equities. We think our clients intuitively get it—it's entirely rational. And it grieves us when, out of anxiety from short-term quotational loss, but with no permanent impairment, a client shrinks his investment, thereby making it permanent.

There is an adage in our business that the best manager to select is one with a good long-term track record who has had inordinate near term underperformance. That would be us.

All that we have said here is common sense. The writing is on the Wall Street wall. Most investors can't read it, just as most couldn't at a major inflection point in 1982. Patient value investors can. We're positioned. It's only about time. Stay fully invested in good cheap stocks and go lie on a beach. God knows we can hardly wait for our portfolios to recover so we can get some beachtime too.

Herbert Abramson and
Randall Abramson, CFA
July 25, 2008

The information contained herein has been drawn from sources which we believe to be reliable; however, its accuracy or completeness is not guaranteed. This report is not to be construed as an offer or solicitation to buy or sell any of the securities herein named. Trapeze Capital Corp., its affiliates and/or their respective officers, directors, employees or shareholders may from time to time acquire, hold or sell securities named in this report. E.&O.E.