TRAPEZE
CAPITAL CORP.

BIRTH PAINS

Sir John Templeton, value investor and human being extraordinaire, said:

> "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria."

We believe that the worst of the decline is behind us and that a new bull market is incubating. In local currencies, from the low on January 21 the TSX is up 16%, the S&P 500 is up 5%, the Venture Exchange (small cap Canada) is up 3% and our equity growth accounts are up somewhere in-between. The pain does appear to be over.

According to our SVA™ work we are bouncing up from significant market valuation levels, levels that also stopped the last bear market. Over the last 15 years, the Dow's low has been 2x Adjusted Book Value and is bouncing up from that level again.

The point of maximum pessimism seems to have been reached in the January panic decline, with more than two bears for every bull, an extreme seen only at major market bottoms. Many technical indicators suggest a significant market low had been reached.

And there is more than $4 trillion on the sidelines. Scared money piling up cash—20% of all U.S. individuals' assets (figures above 17% have always marked major market bottoms). So much cash doing nothing. Buying power as the fear abates.

With 10 year bonds yielding 3.8% compared to stocks with an earnings yield of 7%, stocks should be, by far, the preferred investment, especially on an after-tax basis, and especially in an inflationary environment. As we have reminded clients, stocks today are as cheap as they've been since WWII.

More important, our stocks are even cheaper, and the return expectations going forward are very compelling. While the market as a whole is trading at around 75 cents on the dollar, many of our stocks trade at around 50 cents, or lower, on the dollar. While stocks over time have provided a 10% yearly return, with value managers generally doing better at about 11% annually, we have sought an even better 12% plus per year. However, we firmly believe, that from current severely depressed levels, our returns going forward in the near term should be much higher.

History is on our side. We have suffered other similar periods when our stocks performed poorly in a down market. In each of those instances, when the market stopped falling, as it inevitably does, our portfolios rocketed ahead surpassing their previous high within 18 months of having made that high.

In 1998, when the Asian flu roiled global equity markets, we suffered too, but by the end of 1999 took off and saw our portfolios rise dramatically into 2000. Similarly, we suffered at the end of 2002 and into 2003 only to recover smartly thereafter.

Birth Control

We have done a lot of reflecting on how we might have avoided the drawdown and our last two letters to you highlighted some of it. We don't think we could have avoided a decline, but clearly we could have mitigated the magnitude, especially in accounts where we are entitled to hedge by short selling. Trust us, our SVA™ works.

But, we were too bottom up oriented and didn't appreciate the impact of the liquidity issues in financial-land even though we wrote about the financial-derivatives risks in many of our earlier quarterly letters. We should have been short selling some big troubled financials even when they hit a "floor" in our work because we should have anticipated they might go through that floor, and if they didn't, well, we'd merely make less on the recovery of the whole portfolio and exit the liquid short sale quickly.

Then, too, when our very cheap small cap names became even cheaper, in some instances, dropping a full "break point" (approximately 20%) quickly, there never was an effective opportunity to shrink the position. Such is the price you sometimes pay for smaller cap relative value. Of course, the same volatility works to our great advantage in the recovery, as offerings are scarce.

We should have been selling some of our holdings at their highs—never mind if we thought they should go higher. In our defense, we did not expect the small cap correction to be as ferocious as it turned out to be. But we could have been more defensive.

To add insult to injury, we have been in the right groups—over 50% oil and gas, 15% gold, and several other resource stocks, when the prices of commodities have been skyrocketing—the prospects for these producers have never been better. Indeed, their bigger cap brethren were rising smartly—large cap oil and gas has been the strongest stock market group in the last 12 months. In the end, we were "in the right place at the wrong time". Despite being in the best group, with the cheapest stocks in the group, our small cap oil and gas stocks behaved more like small cap stocks generally and not like oil and gas stocks. Small caps have performed particularly poorly, the Canadian small cap index off more than 30% from its high last year, contributing to our own similar results.

Bottom line, we need to minimize these kinds of painful drawdowns. Having said that, we are currently not short any names because, if we think the whole market is about to take off, this is not the time to be defensive. Our return expectations relative to risk have improved significantly.

Pregnant With Potential

We were attracted to smaller cap names because they were, by far, the cheapest and therefore the most prospective. In some ways, we also thought, more defensive, because of their relative cheapness in their group, but also because they were growing quickly—for example, our energy holdings growing "with the drill bit" so that fast growing reserves could offset a potential correction in the high commodity price.

We're not about to give up on our small cap names. Throwing out the baby with the bathwater. They are cheaper still and even more prospective. As the bull reasserts itself they ought to significantly outperform. They usually do. But, we are not small cap investors. We are multi-cap, "go where you're treated the best", value investors. We have tended to be in large caps too whenever they're attractive. And, for the first time in years, they're cheap now. "The biggest stocks in the S&P are as cheap relative to everything else as they have been in 70 years," says Barton Biggs, a well known market strategist and New York money manager. He is buying large cap stocks and shorting U.S. Treasuries, betting that most people are undervaluing what they think is risky and overvaluing what they think is safe.

We're on the same page. We recently added *Walgreen*, at a valuation that hasn't existed for 14 years. And a Dow stock, *United Technologies*.

We're also buying US retailers for cents on the dollar with consumer confidence at 26 year lows and Americans starting to save rather than spend. But, when consumer confidence hit that low 26 years ago was just when the bull move began after the 1982 recession. And things are better today than then, with Fed funds then 8%, compared to today's 2%, and with credit conditions, as bad as they are, still better than the conditions of 1982.

Retailers are cheap—the S&P Retailing Index was down 33% from its high of last year, and expectations are low. So we now own some U.S. retailers including *Office Depot*, and recently purchased Walgreen and *Ruby Tuesday* and looking for others, wishing we had the cash to buy more of them, and looking to sell something we like less to buy them. We did sell down some gold holdings at higher prices, in anticipation of the correction. And we've reduced other holdings where the risk/reward is not as favourable as we're seeing elsewhere.

Our performance track record for our Canadian long/short composite since Trapeze's inception (almost 10 years), is a 24% compound annualized return after fees and commissions, even after the last rotten 8 months since the July '07 highs. It's an even higher 29% in U.S. dollar terms for U.S. accounts, from the Canadian dollar lift (of which we're now mostly hedged). Our five year performance record for those Canadian and U.S. accounts is 21% and 30%, respectively. Over the firm's history we've had positive returns in over two-thirds of the quarterly periods. In fact, the only calendar year loss we've endured was last year and it was attributable to the two horrible months of November and December. As we are obliged to say in our marketing, "Past performance is no guarantee of future results." Based on the last 8 months, thank goodness. Any client who has been with us for a longer period and is still showing considerable positive results is, understandably, unhappy, but "gets" the process, and forgives us our sins. They get that the last few months are aberrant. But for those clients who came to us near the recent highs and have only known the suffering, they need to be doubly assured that there will be joy ahead. Bulls beget bears and bears beget bulls. And when bears are dying and bulls are being born is no time to get out of what is cheap and prospective and into what is perceived to be safe but overvalued.

March was awful. Another small cap swoon in Canada. April was positive and we think we are setting up for a meaningful up move. Now is the time to be buying what is low. Short-term pain for long-term gain. Trite, but true. Go assure a client, who has only known the pain, that when those contractions come every five minutes is closer to the birth of something good. Go persuade a justifiably frightened client, who is irrationally extrapolating that at the continued rate of the recent decline, his or her account will go to zero, or that, at the very least, his or her retirement may be irreparably prejudiced, that they need to take comfort in the outstanding value and the great likelihood better times soon lie ahead. Our job as professional students of markets is to make them understand that less downside volatility exists today than at the start of the decline. That they own a portfolio of very cheap businesses some of which will succeed big time. That the market sometimes, as now, behaves inefficiently. That that is an opportunity. And that, above all else, investors should not behave irrationally because the market is behaving that way. We need to make the process easier. Investment midwives, so to speak.

Go persuade that fearful client, whose confidence is shaken, that after this kind of decline, it’s much riskier to be a spectator than a participant. Again, history is on our side. A recent Fidelity report noted that this year through February 29th, 2008 is the worst calendar-year start in 75 years since 1933 and the second worst 2-month start in history. The best 3-year performance in history began in March 1933—immediately after the worst 2-month start. From the depths of the1973-74 bear market, the S&P 500 rallied 65% within 20 months, and from the lows of the 1976-78 bear, it rallied 58% in 36 months. After the crash of 1987, it rallied 70% in 33 months. After the bear of 1990, the S&P 500 returned 300% in the next 8 years. Birth pains and the joy of a newborn bull. You’ve got to hang in.

Pregnant Pause

Unfortunately, temporary delays in the business plans of some of our key holdings have overly pressured their share prices in this skittish stock market. In the case of our two largest holdings, *Corridor Resources* and *Allen-Vanguard,* the delays are a function of larger growth ahead.

At Corridor, the company has taken longer to complete each new well as the wells are larger and the company has required more time to extract frac fluids from larger fracs. The company also drilled down toward the Dawson Settlement (the lower zone) but failed to reach it. A disappointment. However, the company discovered the new Frederick Brook shale zone on the way down. A major surprise. These new shale wells are taking time to come to fruition, though the potential reward could be well worth the wait. The company’s annual report just stated: “Corridor believes the Frederick Brook formation presents a new opportunity for the potential development of major new reserves of natural gas for the Company. If successful, the scale of development opportunity in this very thick, organic and naturally fractured shale is enormous, given the Company’s extensive land position in the prospective area.” Wow, the possibility of triplets.

At a minimum, ignoring the Frederick Brook altogether, the stock should move up 70-100% over the next 2-3 years based on the development drilling alone from the upper Hiram Brook zone and that’s assuming gas prices 20% lower than today's. Our confidence is bolstered by the fact that Corridor has drilled 30 wells to date and encountered natural gas in all 30, only one of which is likely to be noncommercial.

Allen-Vanguard has been awaiting significant long-term contracts. We believe they are coming. One was even announced by the U.S. Defense Department in an IDIQ a couple of months back but has not yet translated into an order from Allen-Vanguard’s partner, Lockheed Martin. The delay is due to the fact that the Navy is growing its program size. And, we believe that the same issue holds for the U.S. Marines whose contract has been widely anticipated from the company’s other key partner, General Dynamics. We believe it will be well worth waiting for. The stock should not be at only 5x earnings, one-third of where its peers trade.

In the meantime, the company has paid down over $400 million of debt incurred on the acquisition of its nearest competitor, Med-Eng, last fall from a $300 million equity issue at $9.50 and from its free cash flow. The company also recently refinanced its debt and is about to replace the high cost private equity debt with a lower cost three-year Royal Bank loan. The stock has still not recovered from the announcement of minor development dollars being awarded to three potential competitors for Crew 3, the next generation of IED jammers. Even though the same thing occurred in the past with Crew 1 and 2, but the actual procurement dollars ultimately went to the incumbents, including Allen-Vanguard. The Marines and Navy appear to want Allen-Vanguard’s Crew 3-ready product well ahead of the 2010 Defense Department expectation. The share price has the potential to increase more than four fold over the next 3 years.

Petrolifera Petroleum had a temporary hiccup in production as it declined from over 11,000 boes/d in Q1 '07 to just under 7,000 in Q2 '07, but they are back up to 9,300 today. And, that's without any lift from the waterflooding which they initiated in January and takes a number of months to be effective. We expect them to reach 15,000 boes/d by year end. That makes the company a bargain even without its exploration potential. And, they will be drilling in Colombia shortly where they could have 1TCF of gas and/or 150m bbls of oil. They will also begin drilling in Peru in early '09, another delay, but the prospects there are massive and should be worth the wait. Most important, based on the 15,000 boes/d of production from Argentina alone, the company should be worth at least 50% more than today's share price. And, the share price should more than double over the next 3 years.

Pacific Energy had a miss in its Wyoming exploration target, and took longer to get approval to produce from offshore California. But the key holdback was that the company was forced to raise additional capital and renegotiate terms with its lenders after being unable to refinance the debt incurred on its acquisition of the significant Alaskan assets last year. Operationally though, the company has delivered. Production is at a peak and the company should double production by year end to 12,000 bbls/d now that it successfully restarted its offshore California oil production. The lenders gave the company plenty of breathing room and asset sales along with recouping dollars tied up in a surety bond (now that California is in production) should allow the company to repay a substantial amount of its debt. Meanwhile, the company should be extremely profitable and is trading at a mere 20% of its Net Asset Value. From these very depressed levels we expect a five fold increase in the price of its shares over the next 3 years.

Those companies alone represent about half of our drawdown since the end of October.

Family Members

Our other oil and gas holdings, such as *Orca Exploration, Connacher, Sterling Resources and Canoro Resources,* have held up better and all continued to advance their businesses. However, their small size and relative obscurity have prevented them moving up with the bigger cap energy stocks. We remain unfazed though annoyed by their lack of participation despite such exciting prospects.

Our 3 year target for Orca is more than double the current share price which could come sooner with exploration success. Connacher trades below its NAV and has years of growth ahead where NAV should nearly double over the next 3 years. Today's risked NAV of Sterling is almost double the share price and should grow materially. By 2010, cash flow per share should be $2.25 (its share price is $2.52) without any additional exploration success. The company should trade at 3 to 4x its current share price by 2010 with even more upside from potential exploration success. Canoro Resources still trades only for the value of its proven reserves. And we expect that value to grow materially mainly from the multi-well development program and possible exploration success. The shares have significant upside potential with risk-adjusted NAV more than twice the share price.

Our retail holdings are equally prospective. Even with only 4% sales growth, Office Depot should still bring us a healthy 3 year return because the company has cost cutting efforts underway to boost earnings materially. With over $2.50 of earnings expected for 2010, the stock could nearly triple by then.

New Additions

With Ruby Tuesday, we were able to revisit a stock we owned in the past, though now at a meaningfully reduced price. A chain of events had brought the venerable purveyor of burgers and beer down to a price where we just couldn't say no. At the price we established our position, we got the entire company for less than the appraised value of their owned locations alone, not to mention a business trading at less than 5x expected free cash flow. The stock fell to 80% of Book Value because the company's fundamentals were suffering while management refurbished all of their 700 plus locations in under a year. That impacted restaurant traffic, especially in the softer economy. The company then had to contend with debt covenants which have now been renegotiated. The company has refocused on high returns on capital and we see the stock price more than doubling over the next 3 years.

United Technologies owns Carrier (air conditioning and heating) and Otis Elevators which make up half the business. Pratt & Whitney (aircraft engines), Hamilton Sundstrand (aerospace systems and parts) and Sikorsky Aircraft round out most of the balance. Its businesses are number 1 or 2 in each market in which they operate, have high barriers to entry, operate globally with over 60% of revenues from outside the U.S. and earnings visibility is high due to the long lead times for orders in their businesses. We paid under 14x forward earnings for our shares and calculate that to be about 75 cents on the dollar. The company should continue to maintain its high return on capital while growing at double-digit rates and we expect a 60% increase in the share price from our cost over the next couple of years.

Good Genes

With most of our largest holdings having fallen to "thumbprint lows" on our SVA™ work (price to Adjusted Book Value levels that have only occurred at previous major lows for these individual stocks in past years),we see little price risk left in our positions.

Allen-Vanguard traded as low as two-thirds of Book Value. *CompuCredit* is at the same low (half of Book Value) as during the last recession, yet the company is much stronger. Office Depot fell to Book Value, a price that has stopped its descent on 3 occasions in the last 20 years. Connacher traded all the way down to its thumbprint low as did Petrolifera, Corridor and Ruby Tuesday. Even Walgreen, a big cap company, is sitting at a "floor" at 2.7x Adjusted Book Value, the company having only traded as low as that valuation 3 times in the last 20 years and not seen this valuation low since 1994.

All in all, whether our holdings, have been held back by the general market malaise or by delays specific to them, their return potentials are nonetheless significant. We're currently not holding any positions that we think couldn't at least double in the next 3 years. Who would go from that potential outcome to a pittance of a fixed income return? And pay full taxes on the receipt of that income? And with the risk of the loss of spending power in this inflationary environment?

Without question, stocks today are the best asset class. Over the last 25 years, the Dow Jones Industrial Average (assuming you owned all 30 stocks in equal increments) increased 26 fold, which gave a 14% compounded annualized return. But, over that period, there were 7 declines of 20% or more (the definition of a bear market). Stock investing may be painful periodically, but the end result is clearly better than any other asset class. At Trapeze, our equity accounts have enjoyed an almost 10-year record of over 20% per year, but on three occasions, including the current one, we've also suffered 20% plus declines.

Income Accounts

Our income accounts, which have suffered the odd unrealized loss, still have not enjoyed capital gains to materially augment the interest income. The income holdings currently yield just over 9%, and we do expect some capital gains to finally materialize. About 70% of the holdings are convertible securities or Real Estate Investment Trusts. The underlying businesses are growing and we expect that some of the convertibles will have the prices of shares into which they are convertible move higher allowing our conversion privileges to have substantial value.

Maternity Ward

Other value managers have also performed poorly in the last few months, many of our venerable peers being down over 20% since last year's highs. William Miller of the Legg Mason Value Trust, who had the distinction of beating the S&P 500 for 15 consecutive years, is now down a third from last year's highs. Another value star, Richard Pzena, who manages $21 billion, got smacked by a 40% exposure to financial names, including Citigroup, but he's now out buying more of them, including Citigroup, at distressed bargain prices.

Smart money is buying. Insiders have been increasing their stakes in their own companies for 23 consecutive weeks, with the buying by most senior executives and directors running well ahead of historic averages.

As Sir John said, "Bull markets are born on pessimism." And, there's been no shortage of that. Newsletters that believe we could be approaching a 1930s-like depression. Right. The 1930s, when gold and commodity prices were low and falling, when the farm belt was an idle dust bowl, when money supply was being reined in, when protectionist sentiment led to the Smoot-Hawley tariff law, when unemployment hit 25% and there was no unemployment insurance.

We believe we are past the point of maximum pessimism. 44% of market newsletters were bearish in late March, up from a recent 30.9% and the number of bulls fell to 31.1%, the lowest since the last bear market ended in October 2002. When bears rise above 40%, the S&P 500 has risen 18 out of the last 19 occasions. The recent demise of Bear Stearns, as noted by the Financial Times, is reminiscent of previous bottoms, such as Continental Illinois in 1984, Drexel Burnham in 1990, Kidder Peabody and Orange County in 1998, and Long Term Capital Management in 1998, following which debacles the S&P 500 rose an average of 17% in the ensuing 12 months.

Expectant Managers

Despite the pessimistic headlines, the economy is doing better than most reports would have it and some stock groups are showing it. Despite the decline in house prices and the slowing building activity, housing inventory is declining and affordability is improving. So, maybe the stocks of homebuilders, many up 50% from their lows, are telling you the house market may stabilize sooner than thought. In fact, after a record drop in February, median U.S. home prices in March rose to $200,700 from $195,600 in February, with those believing it's a good time to buy a house rising to 66%.

Businesses don't have excessive capacity—and have strong balance sheets with lots of cash. Wal-Mart and Caterpillar and IBM and Coca Cola and J.P. Morgan and Boeing and Apple and Google are doing fine. So are regional banks and railroads. And of course, Energies are out of sight. As of April 25th, corporate profit growth, absent financials, is up 10.3% with 59.2% of the companies reporting positive surprises compared to 65.1% a year ago, and positive surprises leading disappointments by a very strong ratio of 3.75:1.

U.S. retail sales for March rose 0.2%, a little better than expected. The Baltic Freight Index has risen from 5500 earlier this year to 9300 presently, indicating the global economy may already be turning up. The emerging, higher growth, countries seem to be tracking as usual.

The yield curve is turning up with yields of longer dated T-bills and Treasury bonds rising even as the Fed just lowered Fed funds to 2% (maybe the final cut) earlier this week. The curve indicates the credit crisis is abating and that investors are anticipating better economic activity (and maybe continuing inflation) by taking money out of risk free assets.

Q1 real GDP was a slightly positive 0.6% from the benefits of the narrowing trade deficit and rising inventories. Those inventories may hurt Q2 but we'll soon see the effects of the tax rebates to consumers. All in all, we don't see an economic debacle, especially with all the monetary and fiscal stimulus and the help to exports from the lower dollar. Which dollar, by the way, we think should stabilize and may even tend to rise somewhat, making U.S. assets, including stocks, bonds and real estate, more desirable to the rest of the world.

Which economist wrote the following in the April 21st issue of Forbes?

> "The world clearly has a positive economic bias despite Bear Stearns' tribulations and the U.S. mortgage problems."
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> "Global employment has leaped by hundreds of millions this decade, spurred by capitalism and productivity. With it, global income will hit $53 trillion in 2008, double the rate in 1995, with the U.S. earning more than $14 trillion of the total. While U.S. subprime losses will reach into the hundreds of billions of dollars, the world now earns that amount every three days. And with useful inventions made every few minutes, much more of the world's wealth is in front of it, not behind it."
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> "The sharp U.S. slowdown and the recent loss in the housing wealth should be put in the context of 4.8% unemployment and the housing gains of recent years, which are many times greater than the declines. With 138 million people formally employed on company payrolls and millions more working on their own, the biggest asset by far for American households is their future earnings."

Give up? David Malpass, Chief Economist for 15 years, Bear Stearns & Co. Inc. A realistic bullish outlook, no matter his recently having endured Bear's notorious adoption by J.P. Morgan.

Conception is often done passionately, sometimes irrationally. We believe our portfolios are thoughtfully conceived and, in due course, should engender the returns we expect. We can see the head of the emerging bull. Breathe deeply and push.

Herbert Abramson and
Randall Abramson, CFA
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