



VALUE IS OUR SAFETY NET

Although, ostensibly, our new name “Trapeze” might imply risk taking, we think, as it applies to disciplined value investors, it suggests a cautious and skillful conduct of the money management process. And, after asset allocation, the most important aspect of that process is to look for values, for cheap stocks, reasoning that if those stocks are already low in price, the risk of loss is minimized. Value is our safety net.

Fluctuations Create Opportunity

Because value investors seek to buy low they embrace the market volatility that presents that opportunity. For most investors those undulations and the headlines that accompany them prey on their rawest emotions of fear and greed, often creating an inability to act, or to act sensibly. A famous market operator once said that a good investor was one who had an ability “to act”. As value investors who want to buy low (bargains) and sell high (fully priced stocks) or sell short (overpriced stocks), the fluctuations that intimidate most investors at bottoms or seduce them at tops, represent the opportunity we seek. And we do act. All assets—houses, art, collectibles—fluctuate in price, but are not measured with the frequency and efficiency of the financial asset auction process. We delight in the process. It provides liquidity. It provides an ability to diversify. By asset class, by sector or by stocks within a sector. It provides an ability to hedge through shortselling. Or to husband cash, standing at the plate waiting for the right pitch. It allows us to capitalize on the emotions of the market, and to buy when the fear is the greatest, “when the blood is flowing in the street” and most are selling, sometimes, as in the case of mutual funds that tend to have excessive redemptions, involuntarily, right at the bottom. And to sell when greed has overtaken rationality, as in the financial mania of '99-'00, when Nortel, at \$125, represented 1/3 of the TSX and every cabdriver had to get some, because his brother-in-law said it was going a lot higher. We were short Nortel. And also short Juniper and Bid.com and Priceline.com and many other ludicrously priced stocks that will never see those prices again, many of them not even the light of day again. We were heavily short from '99 through '02, feeding the greed. What an opportunity. You’ve gotta love greed.

But we like longs better. Mainly, because the equity market has a secular upward bias. Economies grow and most companies do too. We take a longer term view of holding our longs which are *investments* as compared to our shorts which are mere *hedges*. Our trader, Dave McCaslin, likes to say, longs are for owning, shorts are for renting. Moreover, heavily shorted stocks tend to be more volatile because if sentiment changes, a lot of people are trying to squeeze through the revolving door at the same time.

We are value investors because we believe that it's the least risky way of making money in the equity markets. There are many other kinds of investors that may be successful for a period of time. Indexers or closet indexers whose bogey is only to keep up with the market averages. Whereas we seek absolute returns. Growth investors who focus on growth stocks, rising stars. Though there have been periods when growth stocks race ahead, over time value is the best bet. We would usually prefer to buy fallen stars, such as Dell, where insider Michael Dell is buying, rather than rising stars, such as Google, where insiders have been regular sellers, \$7.5 billion thus far. Then there are momentum, trend-following investors—buy high, sell higher. For them, “the trend is your friend.” For us, it's merely a passing acquaintance. In fact, when the trend is extended, we don't even want to be acquaintances, and prefer its nemesis, “reversion to the mean”. We always want to make sure we have a chair when the music stops.

As for technical analysis, while some indicators, such as relative strength and sentiment indicators, can be useful in determining oversold and overbought conditions, and we employ them to minimize risk when entering or exiting positions, we think much technical work is voodoo and generally not useful, at least not to us. All the various formations—the head and shoulders (useful in avoiding dandruff but questionable in predicting markets), its cousin, the reverse head and shoulders, all the flag, pennant, candlestick, cup and handle and saucer formations, if they work at all, probably do because so many investors follow them they become self-fulfilling—maybe some justification for taking account of them. Then there are the astrologers and the apparently beneficial effects of a full moon on markets, not to mention on tides and romantic evenings.

Our way seems to work. Since we started Trapeze eight years ago, our long/short composite has enjoyed an annual compound return of 32.5% after fees. Imagine, plain vanilla, diversified, generally unleveraged, long/short, value investing. Guess what? We never sought to get exemplary returns. We never think about shooting the lights out. In the current 5% interest rate world, our bogey is a low double-digit capital gain return of, say, 12%. We think clients would be satisfied with that.

Looking for Bargains

We are always on the lookout for real bargains, reasoning that if a stock is already low much of the risk is out of it.

What creates bargains? Well, sometimes the market as a whole declines. Bear markets like '81 and '90. A crash like '87. The Asian contagion of '98. The days immediately after 9/11. The unwinding of the tech bubble into early '03. In such periods, most stocks get cheaper and sometimes you can pick up great companies at great prices.

Sometimes a particular group falls out of favour because its near term prospects look unattractive. The housing stocks, down almost 40% this year. Retailers, down, in turn, from the concern of the impact of a housing slowdown on consumer spending. The transport group, down from the rising price of fuel, the economic slowdown, and recently, of course, from the impact of terrorist threats. HMOs, down big, from concerns regarding reimbursement programs and enrolment trends.

Sometimes a particular stock has temporary issues that impact it negatively. Good companies suffering a temporary glitch. The backdating of options issue that regulators are examining in the cases of *UnitedHealth Group* and *Delta Petroleum*, both of which we own. The Bhopal tragedy at Union Carbide (now Clorox) some years back, which really didn't affect the potential of its Glad Wrap. Johnson & Johnson, after the tampered Tylenol container incident, which gave its shareholders a big short-term headache.

Sometimes companies are misunderstood and controversial, but good analysis and sound judgement can sort out the issues correctly. *Connacher Oil and Gas* was tough to finance originally because senior management had previous failures and their heavy oil projects were misunderstood. But, as value investors, we know that to err is human and to forgive divine. Despite previous failures, we had high regard for that management and were a lead order for the \$0.475 per share financing in late 2004. The stock now trades over \$4 and, since our original investment, the company has raised \$140 million of additional equity at much higher prices. Clearly that same management is now held in high esteem, its recent supporters having also learned divine forgiveness.

Best of all, sometimes a company is undervalued because it's unknown or underfollowed. Five years ago, our favourite value stock, *Pan-Ocean*, traded as low as \$1.50. It was a classic Benjamin Graham (the dean of value investing theory) "net net" (no, Ben Graham did not stutter) because it had more cash after all liabilities than its share price, so the fixed assets, the business so to speak, were free. Its operations were in Africa and international oil investments were not as well accepted then as today. No analyst followed it until we showed it to oil analyst, Andy Gustajtis, and urged him to commence coverage. He did, and 2 weeks from today, we are to get taken out at about \$59 per share in cash having received \$6.80 worth of its East Coast shares in a distribution along the way. \$1.50 to \$66 in 5 years. Naturally, several analysts now cover it, just as she's about to be gone. We'll miss her terribly. Our African Queen. The gift that kept on giving.

Good Companies

We don't just buy what is merely low—a stock might be *justifiably* low. Nortel. Ford. JDS Uniphase. We buy what is *unjustifiably* low—cheap. But we only want *good* companies. *Real* bargains. We do the fundamental analysis assessing the overall business. We look at the earnings prospects, the free cash flow potential, their quality and predictability. We quantify the company's return on capital and its ability to deploy that capital. The company's Fair Market Value, determined in the context of prevailing interest rates, is then compared to its share price, which, if at a significant discount, makes it a buy. And, we much prefer companies with good and efficient balance sheets, which means a suitable amount of debt.

Of course we need to understand why the shares are cheap. What's the bear case, if any? Is it flawed? Or, in the case of shorts, what's the bull case? Is it flawed?

And we use our SVA™ work to time our purchases and sales. Many of our value investing peers recognize the same values we do, but our SVA™ work helps us to pick the best entry points—i.e., if you wait, this cheap stock will likely get cheaper, as it's on its way, irresistibly, to a certain support level or "floor". In our business that's a major edge.

We try to buy at the floors and sell at the ceilings, preferably also buying when the relative strength is low and selling when it's high. Remember, our two friends, Oversold and Overbought.

Very importantly, too, in addition to the valuations we continuously monitor, the SVA™ work keeps us *in* a rising stock if it stays “on buy” and continues up through a “ceiling” to the next “ceiling”, or gets us *out* at that level if it inflects down, going “on sell”. A real stop loss. A serious edge over other investors who have unscientific, seat of the pants rules about selling such as, “get your original investment out”, “sell on a scale up”, “sell out if it drops 10%”, and so on.

Fear

Fear creates opportunity. Fear tends to prevail when the market declines and the headlines are pessimistic. But, the market is a discounting mechanism. It often starts to bottom just when a classic two quarter recession sets in. But, just when economic conditions appear to be worsening, with resultant pressure on corporate earnings, other market conditions that drive valuations, such as inflationary expectations, interest rates, monetary liquidity, currency levels, savings rates, and corporate cost cutting, may be improving. Yin and Yang. Which is why it's said, markets climb a wall of worry.

Which brings us to where we are today. Rising interest rates are anathema to financial assets, both bonds and stocks. And to real estate too, a highly leveraged asset class, which becomes less affordable. And to consumer spending, 2/3 of the economy, which becomes less affordable too. Huzzaw! After 17 rate hikes, the Fed appears to be done. Recent reports suggest that economic growth is slowing and inflation is moderating. Q2 GDP was reported at only 2.5%, less than half the pace seen at the beginning of the year. Producer prices for July were benign and consumer prices rose at their slowest pace in 5 months. Home building and sales are slow with 28 states actually seeing declines. The number of houses on the market has soared. High end homebuilder, Toll Brothers, reported they are witnessing the worst conditions they've seen in 40 years and the consensus for its '07 earnings has been cut in half. Homebuilders are having their own recession after three consecutive negative quarters. The housing slowdown has begun damaging the job market. The real estate sector has accounted for 44% of jobs since 2000 and employs more than one in 10 American workers.

The University of Michigan's preliminary index of consumer confidence for August dropped more than expected, to the lowest since just after Hurricane Katrina. Leading economic indicators for July fell 0.1%. Wal-Mart, the world's largest retailer, reported same store sales growth of a mere 1.7%, the slowest growth in 6 quarters. Home Depot's guidance was low. Dell's net income for the quarter fell 51%. Ford intends its biggest production cut in 25 years and to increase job cuts further.

Ain't all this great? Is it only Trapeze artists who see the world upside down—who think bad news is good news? History is on our side, and common sense too. When the Fed is about to stop tightening, you typically get rallies in bonds and stocks. Bonds love bad news. Stocks love lower interest rates, but don't want the bad news to get so bad that earnings deteriorate significantly. On the other hand, lower inflation and interest rates boost market multiples providing a powerful offset to weaker earnings. Then too, if the economy slows too much, the Fed will likely reverse course and start reducing rates. And, it's not just about the cost of money, it's about its supply too. So the Fed will make sure monetary liquidity is adequate if things decelerate too far.

The effect of all this worrisome news has been to make the prices of some great companies very attractive. The bad news in the market. Nervous investors are moving to the sidelines. To earn a pittance of a cash return which after taxes doesn't cover the rate of inflation. Of course, they'll be back when the news turns better and be happy paying much higher prices than they otherwise might have, had they been able to deal with their irrational fears. So even as US equity funds post outflows and individual investors pile up sideline cash, savvy corporate insiders have been picking away and cash laden corporations, like Microsoft and Home Depot, have been stepping up their share buybacks.

It's Always A Good Time

Many of our own clients, who have had a satisfactory investing experience with us, nonetheless inquire whether this is a good time to add funds to their accounts when things look so bleak. They don't realize, it's always a good time. Warren Buffett says the best time to invest in the market is "whenever you have the money." That's because the majority of the time the market is going to be higher in 18 months and because we always try to put clients' money where it's likely to be treated the best. Good companies at good prices when interest rates appear set to stay historically low, as currently. Oil stocks because energy prices should continue to stay high and our companies can add so much value through exploration and development. *Rally, Corridor, Petrolifera, Sterling, Connacher, Delta, Canoro, Kodiak, Canadian Superior, Richards*. Gold stocks, because gold should continue to go much higher for several reasons: production is falling far short of demand, particularly additional demand from central banks wanting to diversify their growing foreign exchange reserves and from investors generally; costs for gold companies are rising and require higher offsetting bullion prices; the US dollar should continue to decline making gold cheaper to foreigners; and, gold is a safe haven, the ultimate currency in uncertain times.

In our work, stocks currently are more than 25% undervalued based on the 7 year US bond yield of 4.8%. But we still pick our spots. The oil and gas stocks. Golds. We do, however, think it's possible for some short-term weakness. Maybe another leg down into September. A chance to pick up more bargains. Now we're busy scouring big cap land for more blue chip bargains which are starting to appear. *Abercrombie & Fitch*, trading at a 35% discount to Fair Market Value, and bucking the trend with earnings up 14% in the quarter and raising its guidance. *Lowe's*, at a 38% discount to FMV, and because it should benefit from the "do-it-yourselfer" demand even as, or because, new home sales will be weaker. *Sprint Nextel*, misunderstood, at 40% off with potential for a growth spurt and trading at only 8x expected free cash flow. *TJX*, because discounters such as their TJ Maxx, Marshall's and Winners chains should hold up better in a slowing retail environment. UnitedHealth Group, trading at a 20% discount from its FMV which is growing in the high teens.

The proceeds from our overweighted Pan-Ocean couldn't have come at a better time. We had wished to trim our oils a tad to take advantage of the big cap names appearing on our bargains radar screen.

Our colleague, Bryan Rakusin, regularly expressed his concern about the prudence of having such a heavy weighting in one group and particularly one stock, even if that weighting resulted from a run-up in share price from a purchase at a more modest weighting. Herb teases him that Prudence was the most overweight girl in his grade 9 class. But, of course, while confidence is important, and we're not afraid to make a bigger bet when it's clearly warranted, we know that the unexpected can always happen. We like to say, in markets, don't expect the improbable, expect the impossible. Which is why we think it's important to diversify. So no one torpedo can sink the ship. We'll still miss Pan-Ocean, overweight though she was.

Shuffling the Deck

We regularly update our notional model when we introduce new ideas, eliminate less favourable ones and alter the weightings of some of the existing ideas. Alterations to existing portfolios are made on this basis and new money gets so invested, depending on how current prices affect our then buy/sell intentions. We change our model based on a regular Internal Rate of Return analysis we do for our existing holdings and the universe of ideas we are following. Based on anticipated earnings in 3 years' time, and the multiples that should apply to those earnings given prevailing interest rates, we calculate a resulting price and expected annualized return. So we shuffle the deck and rank the stocks in order of the best returns, risk adjusted by us, to allow us to put more money where we can get the best bang for our buck.

Now, as prices rise or drop, the anticipated returns change. As a stock rises, even if our conviction in the earnings outcome strengthens, its weighting would naturally need to decline because there is less to be earned than on others with greater potential for price improvement. Even if Pan-Ocean was not being acquired, its weighting would have had to be reduced because at its current elevated price its profit potential for gain was not as good as others we own or follow. We'll still miss Pan-Ocean.

The Only Game in Town

Time and again we need to remind clients and prospective clients, when we review their mandates, that in the world as it currently exists and with the tools we have, stocks are almost always the best and even, over time, the safest asset class.

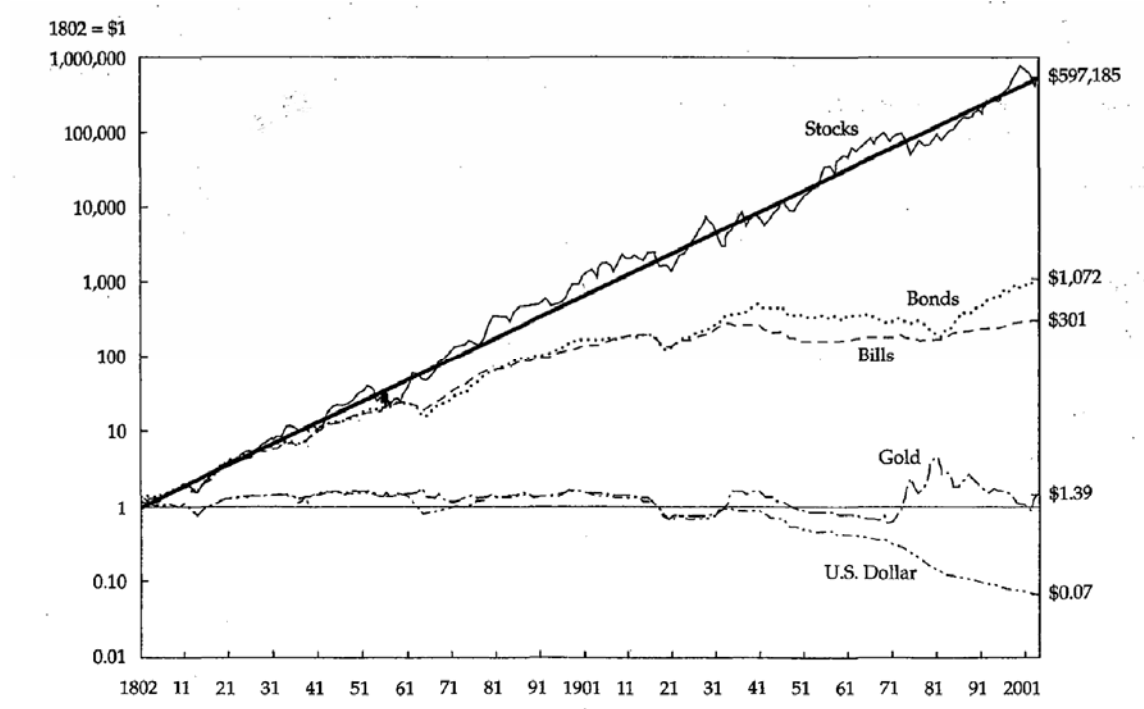
That is the case, first, because we currently live in what we call "a 5% world" (more like only 4% in Canada) where 30 year US treasuries yield 4.95%, 10 year treasuries 4.81% and 5 year 4.76%, where interest rates have likely peaked, for the time being anyway, and where the earning yields of stocks at 7.2% for the S&P500, and the potential return from their dividends, compared to those fixed income returns, are superior. Secondly, even if interest rates went up to combat rising inflation, stocks, with a claim on underlying assets and an ability to adjust through better pricing, would be better than bonds.

As for our income and balanced accounts, in this 5% world, we are invested in corporate debentures (some convertible into equity), preferred shares and income trusts which, combined, yield almost 9%, with the potential for capital appreciation too, through conversions into shares for gains or through sheer market revaluations.

Finally, but most important, in Canada and the US, after-tax returns on stock gains are much superior to after-tax interest on bonds. An investor cannot defer receipt of his annual interest on bonds and has to pay tax on it as ordinary income of, likely, over 40%. On the other hand, until a stock is sold, which could take years, no taxes are payable on the gain. And, when the gain is ultimately realized, the tax rate is much less, 23% in Canada (where only half the gain is included in income) and 15% in the US. For example, assuming a 6% return from both a bond and from a stock sold after one year, the after-tax return on the bond would be a little more than 3%, but, on the stock, almost 5%, which is more than a 50% superior after-tax return on the stock. Dividends from stocks get better tax treatment than interest income too. In the US, dividends, like capital gains, are taxed at 15%, and in Canada, on an after-tax basis, a 6% interest return would be needed to match a 4% dividend return.

And as we said earlier, pre-tax returns on stocks, after inflation, over time are far superior to any other asset class, including bonds, T-bills and gold. In fact, over the last 200 years, stocks have provided a long-term equity return, after inflation, of 6.8% a year. An accumulation in equities with reinvested dividends almost doubles in purchasing power every 10 years. Look at it graphically in a chart by Jeremy J. Siegel, from "The Long-Run Equity Risk Premium", CFA Institute Conference Proceedings, 2004:

Total Real-Return Indexes for a \$1 Investment in 1802, 1 January 1802 through 31 December 2003



Our “hurdle rate” of 8% annually to the client before we become entitled to performance fees is based on the premise that takes into account the long-term return of stock indexes and assumes a client should be able to get 8% on his own, so we should only share if we add value over that. And, we think we can add additional value, if only because, again, the odds of our doing so, as multi-cap value investors, favour it. According to data from investment guru Phil DeMuth of Conservative Wealth Management, if you had put \$1 into S&P500 in 1927 and held it until 2004 you would have had the staggering sum of \$2,273 of total return (dividends and capital gains). But, if you had put \$1 into small cap value stocks (the 1/3 of the smaller half of the NYSE that had the lowest price to book value ratios), that dollar would have grown to an astounding \$58,992.

Power of Compounding

Wait, it gets even better. Investment guru, Richard Russell, always expounds on the power of compounding which he calls “the royal road to riches”. Einstein called it “the eighth wonder of the world”. Russell recently noted a study of Market Logic of Fort Lauderdale, comparing the return of an investor who at age 19 puts \$2,000 per year into his IRA for only 7 years at an average growth rate of 10%, to that of his friend who makes no contributions until age 26 and then continues to contribute \$2,000 per year at the same 10% return until they both reach 65. Incredibly, the guy who started first, but made only 7 contributions ends up with more money (\$930,641) than his pal who made 40 contributions, but started later (\$893,704). The first guy had 7 more years of compounding which were worth more than all of his pal’s 33 additional contributions. The first guy’s investment grew 66 fold while his pal’s only 11 fold. Neither of them, we might add, held Pan-Ocean or they could have really retired in style.

And even better still, when you can compound on a pre-tax basis, as in the case of holding a growth stock, such as Pan-Ocean, for years without selling, and then, on sale, paying the tax in Canada at half rates, or in the US at 15%, compared to compounding on an after-tax basis fixed income received and fully taxed annually, there’s no contest. Which makes our superior performance record even better.

We’re Getting Better

We think we’re getting better at what we do. Better informed, better advised, better people. Which doesn’t mean we can achieve better returns. That depends, to a great deal, on the environment and its potential to allow such returns. But it does mean, hopefully, that we can achieve whatever returns we can achieve with lesser drawdowns, i.e., with less negative volatility. We will increase our efforts to find securities which trade at prices below their intrinsic financial worth.

We want to avoid losing, even when the overall market does. Smart capital allocation, really cheap out of favour stocks, and diversification among companies and industries. Smarter short-selling should help too. We’re proud that, year to date, we have profited not only on our longs, but on our shorts too. We need to sell shorts only when they are at or near our “ceilings” and not forget to take the profit. And, limit our shortselling when the overall market is “on buy”.

We need to learn from our mistakes. Keep them on file to remind us.

We need to have lots of conviction to enter an idea. And when in doubt, get out. It's better to be safe than sorry.

We want to get the direction of a stock or the market right and be less concerned with the magnitude of the potential move.

We will continue to be contrarians, but not religiously so, recognizing that often the consensus is correct. We are currently only 9% short, but if our bullish posture changes, we'll not hesitate to raise the percentage of shorts to protect from loss.

We will be wary of inflation and of the potential for a capital crisis if the selling of the US dollar turns into a rout. We will continue to hedge our currency exposure as best we can.

We will take a broad interpretation of our "growth" mandate, and if we can find a fixed income idea that can compete with an equity return, such as the 12% yield on the discounted GM bonds we recently held, for a capital gain too, we'll incorporate it in the portfolios.

We'll try not to overrule an SVA™ "sell signal" unless we can justify that the decline is likely to be minimal and temporary and only if the stock trades at a substantial discount to its Fair Market Value.

We will continue to focus on clients' after-tax returns, taking tax losses where it makes sense and, for Canadian accounts, offsetting income with reasonably priced flow-through shares. And, for US accounts, being mindful of the preferable treatment of long-term gains.

We intend to soon lower clients' capital costs and enhance returns by implementing programs to sell put and call options, collecting the premiums from selling put options at the "floor" of stocks we would happily buy there and selling call options at the "ceilings" of stock holdings we would be content to sell at those levels. Selling only. With the benefit of the SVA™ work, which is ideally suited to selling put and call options thoughtfully, improving risk-adjusted returns and lowering volatility.

We will be hard-nosed about our investments and never allow ourselves to fall in love with a position or a group if it can't still be justified. Except of course for Pan-Ocean. We liked her even before she was Pan-Ocean, when she was Ocelot, and then PanAfrican. Other fickle money managers traded her out, never appreciating her innate beauty. Maybe we could have gotten serious and committed to compound together, forever. Just maybe, too, we could have made another beautiful spinout together, like our precious little East Coast. Pan-Ocean. Taken from us in her prime. But we are consoled with what we think could be other potential Pan-Oceans in our lineup. Corridor, Sterling, *Globestar*, Delta, Rally and Etruscan. A bevy of beauties. And we're still interviewing.

Herbert Abramson and
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