VALUE CONTRARIAN
ASSET MANAGEMENT

2010 Year End
Value Contrarian Equity

Dear Partners,

Just as it took several years for the market to see that Paul Volcker's (1970's painful interest rate hikes) policies would lead to declines in inflation and interest rates, it will take several years for the market to realize the Fed's current [QEII] policies are highly inflationary.

Felix Zulauf
Zulauf Asset Management
January 2011

There's no sure bet in the world but I would say holding (Chinese) Renminbi (currency) is one of the closest thing.

Kenneth Ho
Global Head Investment Solutions
Bank Julius Baer & Co

The central moral imponderable with regard to China, is the middle class (and lower-middle class apartment owners), which up to now have seemed content to trade political freedom for rising incomes and stability. But at some point this trade-off is likely to fail; the regime will find itself unable to deliver the goods, or the insult to the dignity of the Chinese people will become too great to tolerate… We cannot predict when this tipping point will occur, but its eventual arrival… is bound up with the very logic of modernization itself.

Francis Fukuyama
Senior Fellow
Stanford University

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Quantitative easing (QEI &II) has already suppressed real interest rates and allowed assets such as commodities, stocks and commercial real-estate to appreciate. The question remains, once QEII disappears (at the end of June) how long will rates remain abnormally low?

According to Bill Gross, the respected Chief Investment Officer of bond house Pimco, it is fixed-income investors who are being "haircutted" by this low real interest rate environment. Says Gross, "…to put it bluntly, they are robbing savers and taking money surreptitiously from longer-term asset holders whose assets [ie: bonds] don't anticipate future inflation."

Recently, Gross publicly stated his $200 billion + bond fund had no holdings of U.S. Treasury Bonds, having sold the last of his bonds this past February. Investors should take that as a strong hint from the "smart money crowd".

Over the past two years we have made a significant amount of money in our "China adjacent" investment, the Hong Kong Stock Exchange. We prefer to invest in "superior businesses" that will benefit from the China growth story, while avoiding direct investments in Chinese companies. The typical problem with "China story" stocks is that they are often ridiculously expensive with sub-par profitability. Expensive stocks don't provide a "margin of safety" if growth does not pan out. As value investors, these are stocks we may lust after, but often cannot justify owning.

Nonetheless, an important key to long-term investment success in China is patience. Bear markets and future political turmoil (whenever that may occur—see above quote) can be the catalyst for more reasonable valuations and better risk-reward metrics.

And where do we see future China opportunities? European luxury goods companies are increasingly relying on Asia and the Chinese domestic market for their growth stories. These are highly profitable businesses with legendary brand name pricing power—take PRADA as one example. Patience will be the key to our investment success in this region. And one always must remember it's not possible that something can be a good investment regardless of the price paid. "Price paid" matters very much!

On a final note, Eastern Canada has not, as yet, experienced a painful downturn in the residential real-estate market since the cycle last bottomed in 1995. Sixteen years of near uninterrupted rising home prices tends to dull one's memory (and pain) of past housing downturns.

The main catalyst for a housing slide would be an unexpected and significant rise in mortgage rates (through rising long-bond yields). The exact timing of such conditions is unknown, but most likely to occur when least expected. Overleveraged buyers who forget the lessons of history and the fact that real-estate is a cyclical business, do so at their own peril.

2010 Performance: +11.02%

January 1, 1997	—	$1,000.00	(inception NAVPS)
December 31, 2010	—	$2,655.41	(NAVPS)
December 31, 2010	—	$263.14	distribution per unit
December 31, 2010	—	$2,416.00	(NAVPS after distributions)

The fund ended the year with a net asset value of $2,416.00 per unit, after a distribution of $263.14 per unit. Your distribution was automatically reinvested in additional fund units (see your attached personal V/C Fund year-end statement).

The good news is that your fund produced double digit returns for the second year in a row. We did this without going "whole or half hog" into the volatile commodity, mining and gold sectors. As Buffett clearly explains, there are two types of assets one can buy. One is where the assets itself delivers a return to you. These assets would include rental properties, stocks or a farm.

Then there are assets that you buy in the hope that somebody else pays you a higher price sometime in the future, but the asset itself doesn't produce anything. Think "art" or a bar of "gold". The latter asset, Buffett explains, is mere speculation—nothing illegal or wrong about that.

It is an entirely different game to buy a lump of something and hope that somebody else pays you more for that lump two years from now than it is to buy something you expect to produce income for you over a period of time. Think Nestles.

Now for the not so good news in 2010 (especially for the "glass is half empty" crowd). We had an extra-ordinary capital gain on our large holding of TD Split share corp. The good news is that we produced solid gains with this investment over an extremely volatile period in the financial markets.

TD Split is a 2X leveraged play on TD bank common shares. Invest $1 dollar, and receive the equivalent of $2.00 worth of TD bank shares. In return for potentially turbo charged capital gains, we gave up the right to receive the majority of TD's substantial dividend. Investors who bought the other half of this investment vehicle, TD Split Preferred, received turbo-charged dividends but forfeited all future capital gains on the underlying TD stock.

To make a long story short, in 2001 we started buying these TD Split shares in the $16 dollar range. In late 2010 this TD investment vehicle reached its termination date. As a result, we crystallized a large capital gain with a deemed disposition at over $73 dollars. Today, TD common shares trade at $85 dollars.

The "glass is half full" crowd were first and foremost content that we made such a large gain, while grudgingly resigned to the fact that taxes are a part of life. "Better a large profit than a loss" in the eyes of these investors. At the end of the day, our investment decisions at VCAM are based on value and the potential for profit or loss. Tax considerations, while important, are next in line.

As part of the re-organization, we elected to retain our pro-rated share of regular TD bank common stock. TD now represents your fund's single largest holding at approximately 8.0%. These shares shall remain a core holding of the fund.

Why do we like TD? TD culture, Ed Clark, the CEO and of course the excellent underlying businesses. Ed Clark said it all in this year's annual letter to TD shareholders. "Our focus on lower-risk, reliable and steady streams of retail earnings [not volatile-risky capital markets/investment banking]… I believe that it will continue to drive our results."

Contrast this with the remarks of the Royal Bank's CEO, Gord Nixon in his 2010 annual letter to shareholders. "We continue to …build our global capital market platform in all major geographies including Asia… Our goals are… globally to be a leading provider of capital markets…" Ouch!!

Is Royal morphing into a wanabee Goldman Sachs?? Have they not learned from the disasters of previous banks that tried to muscle in on the "bulge bracket" investment banks such as Goldman, Deutch Bank, Morgan Stanley, etc…When it comes to sales and trading, every bank on Wall Street knows that unless they're in the top three in the mega-flow businesses such as rates, foreign exchange and commodities they're wasting their time. Moreover, one need go no further than the homemade disaster CIBC inflicted upon its shareholders when it ventured into the U.S. investment banking-capital markets business.

Unlike the Royal, TD has a nicely profitable retail platform in the USA—with 1, 300 branches. Since the credit crisis they have managed to make a number of bargain priced acquisitions in the States, the largest being the $6.3 billion Chrysler Financial purchase (done at book value).

Moreover, there awaits a potential home-run opportunity for TD's US retail bank. Unlike in Canada, up until now, most Americans don't visit their local bank branch for a home mortgage loan. This is now changing, as the roles at disgraced mortgage lenders Fannie Mae and Freddie Mac are in the process of being drastically reduced by congress.

Over the next 5-10 years, U.S. retail powerhouse banks such as TD, JP Morgan, Wells Fargo, Bank of America, and U.S. Bancorp have the opportunity to further grow into the bread and butter business of retail mortgage lending.

This is a sensible business to grow into after U.S. home prices have already imploded, thus reducing the risk of bad collateral. U.S. home and car lending may not be a glamorous business but if done correctly, will add to TD's bottom line for years to come.

In our opinion, the Royal's foray into the global capital markets business is an eventual "blow-up" waiting to happen. Whether it occurs in five or ten years from now, Royal will come slinking home — saved by its domestic banking franchise. The only question that remains is what will be the final opportunity cost to Royal bank shareholders.

TD and Royal are two Canadian banks with two very different international strategies. In this case, we prefer boring to that of sexy.

It's a humbling business managing money. "Value traps" (think of sand traps in golf) are easy to fall into, but difficult to extricate oneself from in a pleasing (ie: profitable) manner. Your manager fell into a classic "value trap" with the purchase of shares in Urbana Corp — a closed-end fund trading on the TSX.

Simply stated, a "value trap" is a stock which seems like a great bargain but which in reality is a cross between a beautiful mirage and a pit of quick-sand—it's easy to buy into, but very difficult to exit with a profit.

The interesting part of Urbana is that it owns a quality portfolio of public and private global stock-exchanges. It also trades at a large discount from the underlying value of the portfolio.

Unfortunately, as the fund is currently structured, there is no simple route to reduce the persistent discount. Instead, the stock has sunk to an even larger discount (30%-40%). The markets have lost confidence in the investing prowess of Urbana's management as they have steered away from their original investment objective of owning stock exchanges.

Moreover, as Urbana has no specific windup date, no annual retraction clause and no mandatory share buybacks, eliminating the discount to net asset value is next to impossible.

What about voting Urbana management out of office? Sorry, Tom Caldwell and his gang have voting control, despite owing a minority equity position (10 million voting shares—70 million nonvoting shares). So how does one spell "value trap" today? U.R.B.A.N.A Corp!!

Maybe one day Mr. Caldwell will decide to put the interests of the majority equity holders first – or at least put it to a vote every five years. Until then, the gravy train of fees will continue for Caldwell. Your manager has learned an expensive lesson—my apologies to all.
(Note: Urbana stock price $1.30—March 18/2011; net asset value $2.02=36% discount)

OUTLOOK 2011

So the question is (in today's new Middle-East) what do you get. [Do] you get 1979 in Iran or do you get 1989… in Eastern Europe? In Eastern Europe they turned towards democracy. In Iran they turned towards a backward theocracy. And I have not seen a single case in which the Muslim Brotherhood of its various shades and hues turns toward the European liberal model. They invariably turn to more closer or identical to the Iranian Model.

PM Benjamin Netanyahu
CNN Interview
March 17, 2011

In the Middle East those protesting agree completely on removing existing regimes but thoroughly disagree about the future. One group represents modernizing elements who essentially want to share the freedom and democracy we have; the other one Islamist elements who have quite a different conception of how the change should go… Same of those [Islamist]… wanting change want it because they regard the existing regimes as not merely too oppressive but too pro-western, and their solutions are a long way from what provide modern and peaceful societies.

Former PM Tony Blair
Wall St Journal
March 19, 2011

The fact that inflation now is 1 or 2 percent, you know, doesn't mean anything… If you jump off the 50th floor… at the 45th floor, you know, you should not judge the success of your effort by where you are at that point.

Warren Buffett
CNBC Interview
March 2, 2011

Certainly the Israeli Prime Minister's words and Mr. Blair's don't bode well for future peace in the Middle-East (or stable oil prices). What most commentators today totally fail to mention is that modern democracy is not part of Arab culture, history, clan, tribe or family make up. For more on this topic do read—"The Strong Horse" by Lee Smith.

According to former financier Conrad Black, the recent turmoil in the Middle-East has also exposed the never talked about truth that "Israel is, in the end, a red herring to the whole Muslim world, useful to distract the masses [the Arab St] from the almost uniform misgovernment inflicted on them, which is their real grievance." Yet, Tony Blair is also correct when he states that "…we are deluding ourselves if we don't think its outcome (Israeli/ Palestinian conflict) matters profoundly to the region and the direction on which it develops. "

In our humble opinion, the present events in the Middle East mean that the region will remain volatile, unstable and prone to future conflicts. And while we in the west hope for democracy, the rule of law and human rights, the reality on the ground in coming years may not meet our "western" expectations.

The outlook over the next few years seems to be that if the U.S. government does not drastically change its course, the present policies will lead to significant inflation down the road. According to many knowledgeable observers, you cannot run the kind of deficits the U.S. is running today without being enormously inflationary.

Taxing a whole lot more or reducing spending are two ways to deal with the deficit. However, these are not the easy routes for politicians to take. One need look no further than the Portuguese parliaments recent rejection of an austerity plan to realize that politicians will almost always avoid implementing the "harsh medicine" to reduce deficits.

Inflating your way out of chronic deficits would be the easy path for the politicians to take. Unfortunately, most people don't realize that inflation is the ultimate stealth tax!

At a CIBC conference your manager recently attended, Larry Rossy, the CEO of Dollarama, also warned of the existing inflationary pressures his company was experiencing in China. Just a few years ago China was supposedly exporting deflation. Now however, it appears that Chinese inflation will be exported to the West.

We can't predict where the markets will be next month, let alone next year. But what we can do is research and learn from history. We can see where the similarities of the past may apply in today's world.

For example, how did the stock markets perform during the extreme inflationary and rising interest rate environment of the late seventies?

From February 1978 to November 1980 the S&P 500, over this 32 month period, rose 61.7%. U.S. inflation went from 6.43% in 1978 to 12.65% in November 1980. While the Fed funds rate over this same period climbed from 6.78% to a whopping 15.85%!!

So what's one of the important investment lessons learned during inflationary periods? History shows that equities can produce outsized returns in this environment. And you don't want to be stuck in fixed-income investments when inflation suffers a serious break-out —other than as a temporary "parking spot" for cash.

Maybe Buffett is on to something when he recently explained that, "…there have to be consequences to issuing paper money. There are consequences to the Fed buying lots and lots of securities… If it was that easy, you know, we'd be doing it all the time."

Year-End Management Note

> ***It takes 20 years to build a reputation and five minutes to lose it. If you think about that you will do things differently***
>
> ***Warren Buffett***

As we have always stated in the past, we cannot promise any particular results, only that investments for your fund will be selected based on **value, not popularity**. We view our fund shareholders as our partners, and we assure you that the protection and growth of your capital will continue to be paramount in our thinking.

We aim not to be the biggest, but one of consistent performance, while protecting our partners' capital, even if that means limiting the Fund's size or closing it in the future. We want to enjoy coming to work everyday. We view the Value Contrarian Fund more as a private partnership, where "membership has its privileges".

Being the second largest shareholder and manager of your fund is certainly no guarantee of superior long-term results, but it may raise your comfort level having my financial interest aligned with yours. **Simply stated, your returns are my returns.**

I would like to take this opportunity to welcome my new assistant, Ms. Li Zhou. As always, the smooth operation of Value Contrarian Asset Management could not have been conducted without the superb efforts of Ms. Zhou. Her patience and calm demeanor are very much appreciated.

We also appreciate the wise counsel from our Deloitte & Touche audit professionals — Haig Vanlian and Dominic Deli Colli.

Finally, we would like to thank our shareholders for the trust you have placed in us during the past year.

We do appreciate your referrals of qualified new fund investors. Don't hesitate to call us for a personal review of your investment portfolios.

Call today: (514) 398-0808.

Respectfully yours**,

Benjamin D. Horwood
Portfolio Manager
March 28, 2011

P.S. Do visit us at our web site: ***www.valuecontrarian.com***

** We're often asked: "When is the best time to invest in the Value Contrarian?" Although there is no best time, since it is impossible to time the market, a preferable entry point is when the fund has produced a month of negative returns or a year of underperformance. Unfortunately, human nature prefers the exact opposite.