VALUE CONTRARIAN ASSET MANAGEMENT

BANK OF COMMERCE CENTRE
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2006 Year End
Value Contrarian Canadian Equity

Dear Investors,

> ***What we are betting on is that the perceived risk exceeds the actual risk. That's fundamental to the theory of everything we do (regarding investing)…Our mission in life is to try to go into things where there's a lot of (temporary) trouble.***
>
> ***Wilbur Ross***
> ***WL Ross & Co***
> ***(Billionaire Investor)***

> ***Do you know how we can tell when we really have a winner (investment)?….It's the ultimate bell weather.***
> ***Its when our clients get really angry – when they're so mad that they make us sell it. Five clients made us sell Wal-Mart. They didn't even want to talk about it…It's so ridiculous. The way people feel about Wal-Mart is so classic.***
>
> ***Arnold Van Den Berg***
> ***Century Management***

Recently, there was an article in the Financial Times of London that cited numerous studies which have shown that most investors do worse than the funds they invest in because of the tendency to put money in after a fund has had a big run-up.

From our experience, when a Value Contrarian investor makes their initial investment, it is almost always after 3-6 months of continuous positive gains. As a result many investors, during their initial purchase, end up buying units at or near the funds net asset value peak for the year. 2006 is a prime example of such behavior.

After having hit a peak net asset value at the end of March, the Value Contrarian fund suffered three consecutive months of negative returns during April, May and June. Now here are some interesting facts. Out of the 15 purchases made during 2006, only three were made during a month of negative returns. Most intriguingly, those three investors were all repeat investors. Congratulations and thanks for your vote of confidence!

Unfortunately, the sole redemption last year was made on June 30th, which also coincided with the fund's low point for the year. And while there were no fund purchases on July 1, if one had followed a contrarian strategy, the result would have been a 10.7% gain by December 31 (or 21.7% annualized). Sometimes timing is everything.

The fund made up for lost ground in the second half of 2006 and reached a record net asset value by September 30. Low and behold, in September the fund started to receive investors' monies again. At the risk of sounding like a broken record, while one can't time the markets, experience has shown us that if you force yourself to follow a contrarian strategy (i.e., buying during periods of negative returns) you are more likely to incur superior returns in the long run.

Today, "Get Me In" seems to be the battle cry of many investors. Aversion to risk is conspicuously low, whether it be in junk bonds, emerging markets, credit default swaps or commodity markets. The market's complacency is, according to most analysts, tied to the vast amounts of "liquidity" (easy credit) sloshing around the globe.

Recently, Blackstone won the drawn-out battle for Equity Office Properties REIT ($38.9 bn), making it the largest leveraged buy-out on record. In our opinion, when the "big bubbly" investment party ends, the greatest future pain for investors will be in junk bonds and private equity (LBO). Juicy returns in both of these areas have led to a flood of investment dollars.

The present prolonged stretch of low volatility in the stock markets, combined with low interest rates, may be setting us up for deeper pain when the business cycle eventually turns. However, the party can last far longer than most investors expect. Remember how many years "irrational exuberance" lasted during the 1990s before a major correction occurred (December 1995-August 1998).

Some quick observations. Last week in Toronto I attended the Scotia Capital Energy Summit Conference. Eleven major Canadian energy companies showed up to give their "spiel" to fund managers and assorted institutional investors.

Most revealing was the fact that despite a major snow storm in Toronto, the room was packed and extra seating was needed at the back! The CEO of Shell Canada clearly stated that the world was not running out of abundant energy sources. According to Mr. Mather, there are still "massive untapped resources to develop". He not does see the likelihood of a short term collapse in oil prices with OPEC keeping $60 as a floor on prices. We would agree.

Yet for "contrarian" investors, the popularity of this conference was an opening sign (small crack) against continuing record energy prices. However, the ultimate contrary indicator will be when the front cover of the Economist/Fortune magazine heralds "Will High Oil Prices ever fall?" Eventually (hold your breath), oil prices will drop to $18-$25 a barrel. Do note that this is significantly in excess of $10, where oil prices bottomed out in 1998.

Regardless of China & India, human ingenuity and greed will eventually bring forth a gusher of new energy sources and conservation programs. Think coal, hydro and nuclear power, solar, wind, and various alternative/new technology sources. Moreover, any type of slow down/recession in the West would clearly have a negative impact on energy demand.

Yes, we fully admit that under $30 oil prices will not occur in the short term. Think 5-7 years before the supply/demand equation leads to steep price declines. Moreover, over the next five years we are willing to predict at least one more significant blow-up (war) in the Middle East. Such a geo-political event, while perhaps leading to record oil prices, would be sowing the seeds for a significant price decline once the dust settled! Nonetheless, there will be plenty of trading opportunities before then.

One casualty of the recent decline in oil prices will be the energy heavy TSX Index (28% of the Index). Barring hurricanes or further Hezbollah blunders, oil prices are no longer in the $70-$80 range. Thus, prior to the second half of 2007, the TSE energy sub-index will factor in negative year-over-year cash flow comparisons – a situation not conducive to higher energy stock prices. Nonetheless, your fund is well positioned to avoid any negative fallout from this scenario.

The positive story is that falling oil prices have the effect of moderating the inflation rate. And lower inflation means interest rates are less likely to rise. All of which is good news for the equity markets in 2007.

2006 Performance: +10.1%

January 1, 1997	—	$1,000.00	(inception NAVPS*)
December 31, 2006	—	$2,604.14	(NAVPS)
December 31, 2006	—	$89.93	distribution per unit‡
December 31, 2006	—	$2,514.21	(NAVPS after distributions)

The Fund ended the year with a net asset value of $2,514.21 per unit.

Your distribution was reinvested in additional units. These new units appear on your personal December 31, 2006 Value Contrarian statement.

Once again, a benign interest rate environment and rising commodity prices (metals, mines, golds) powered the TSX to its fourth year of double digit gains. However, the party for investment trusts abruptly ended in late October to the detriment of many investors' personal net worth.

All of our existing trust units (Livingston, Aeroplan, AutoCanada, FirstNational) have two elements in common – a low pay-out ratio and excellent organic (or acquisition) growth potential. These trusts are not likely to cut distributions when the 31.5% tax kicks in.

We continue to hunt for further opportunities in the business trust sector. Even as the 2011 tax deadline looms, there still exist trusts which meet our "superior business" criteria. It's all a question of purchase price.

2006 produced no "torpedo" stocks in the V/C fund portfolio. These are stocks which keep the makers of Nexium and Zantac in business. Rather, it was a year of many singles, doubles and the occasional triple such as Cogeco Cable. Yet our aversion to cyclical commodities and a high cash position (26%) put a damper on achieving excess performance.

The Fund's cash position results from our desire to uncover value first as opposed to buying stocks merely for the sake of avoiding having idle cash. As always, our top priority remains preserving investors' capital. Many of our partners have often told us over the years that they don't want to take the same risks in the V/C fund as they do in their own businesses. To that we say: "we hear you loud and clear!"

During the quarter there were a few takeover announcements of companies held in the portfolio. These included T.D. Banknorth, Retirement Residences Reit and Realogy. In addition, during December the bank of New York agreed to acquire Mellon Bank in an all-stock deal that would create the world's largest securities servicing company and one of the biggest money managers. We intend to remain long-term investors in the new Bank of New York Mellon Corp. It is an excellent business with the bulk of its revenue based on reoccurring service fees as opposed to volatile interest rate spreads.

We took profits after a long holding period in both Talisman Energy and Alcan. Unfortunately, both stocks subsequently moved higher on takeover rumors. Our knack for selling just prior to a takeover has occurred in the past – with Talisman and Alcan we may just have a bit more mud on our face!

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* Net Asset Value Per Share

‡ Total distributions reinvested 1997-2006: $560.44(per unit)

In the quarter we took "look-see" positions in two quality businesses which are also eventual takeover candidates, Standard Life and Quebec based OSB[†] producer Norbord. Both were out of favour at the time of our purchase and have subsequently moved up in price, thus thwarting additional purchases (for now).

Investment ideas from your fund arise from many sources, but the common thread is our constant perusing of numerous publications and annual reports. Very often great leads come from money mangers or institutional investors who we deem as "smart" money. Examples would include Jack Byrne at White Mountain Insurance, Eddy Lampert at Sears, or Wilbur Ross.

In the late fall I participated in the annual stock picking contest sponsored by the leading French Canadian Business publication Les Affaires. The round table discussion (with 5 other professionals) afforded your manager a significant portfolio idea – Atrium Biotechnologies.

No, we have not lost our marbles, as this is not an investment in the high stake biotechnology sector (ignore the word "biotechnology" in Atrium). What initially piqued our interest was the fact that in October RBC purchased 3.9 millions shares in a "bought deal" at $15.80. Prior to the offering, Atrium was trading at $16.25.

Unfortunately, RBC couldn't find enough buyers and got stuck with Atrium stock in their inventory. By November the stock was trading at $14.50 - $15.00. Ultimately, RBC would have to sell before year-end at a reduced price. We knew this and sensed a potentially good deal. Now it was a question of whether we wanted to own the type of business Atrium was operating in. Did it have the characteristics of a "superior" business with shareholder oriented management? What were its growth prospects? Was the stock reasonably valued?

Atrium is a publicly-listed Quebec-based company with two lines of business. In their main business they produce active ingredients and specialty chemicals for the cosmetics, pharmaceutical, and nutrition industries (approx: $180 million sales). Their second business develops, manufactures and markets over 1,300 products in the area of vitamins, minerals and specialty nutrition products (approx: $100 million + sales). More than half of company sales are from their European operations.

Atrium's management and major shareholder (Aeterna Zentaris) was clearly working to increase shareholder value. After the bought deal closed, Aeterna converted its remaining multi-voting shares held in Atrium to one vote. Aeterna also decided to distribute its 36% remaining interest in Atrium to its shareholders in early January 2007. These moves would make it easier for Atrium to raise capital for acquisitions. It would also make Atrium completely separate from Aeterna and thus a potential takeover target.

We also like Atrium as a business because it produces lots of free cash flow, requires little capital expenditure, and occupies a niche which is not highly cyclical. Atrium has grown mostly through acquisitions and will continue to consolidate its target markets. Trading at approximately 15X 2007 earnings, we expect to own a growing investment for many years.

[†] Oriented Strandboard (plywood substitute)

2007 Outlook

> ***Be greedy when others are fearful, and fearful when others are greedy.***
>
> ***Warren Buffett***
> ***Berkshire Hathaway***

> ***In Pleasantville…everything appears normal and orderly and very calm but under the surface it is very oppressed and unnatural. The current (economic) environment is a bit like that. Everything is pretty benign and amazingly good…on the surface – but underneath, we are certainly not in a state of equilibrium…But I don't see the catalyst for change yet.***
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> ***Martin Barnes, Editor***
> ***Bank Credit Analyst***

Over the past four years we've had a big stock market train in motion. The train has clearly been moving in one direction. Who are we to predict when it will stop moving? Bull markets don't end on a dime. Nor do they end simply because stocks are overvalued. Low interest rates, easy credit, global liquidity, investor complacency, and fuzzy memories of bear market losses are all the necessary ingredients for a stock market "melt-up". Of course, falling oil prices also help. Actually, a 5%-10% market correction would be a positive for the long-term health of the equity markets.

Today, the consensus opinion is overwhelmingly that we are in a benign interest rate environment. Few of the "experts" are talking about the possibility of rising rates. An unexpected rise in long bond yields (i.e., from 4% to 4.75%) or, alternatively, a short-lived financial crisis could be the catalyst for an overdue market correction. Nonetheless, we don't see signs of a 2000 style bubble or mania amongst the retail investing crowd (yet)!

The longer this bull market lasts, the more important individual stock selection becomes. We are entering a period where the "rising tide" becomes much narrower. Large-cap global companies often out perform later in the business cycle.

We remain cautiously optimistic and contemplate investment opportunities arising when one least expects it. We also look forward to increased volatility in the financial markets – volatility is our friend. Ironically, it will likely take some type of financial (Iran) crisis before we see a drop in interest rates.

As always, capital preservation remains upper most in our minds and is fundamental to our investment process.

Year-End Management Note

> ***Probably 99.9% of investment management firms that sponsor mutual funds are there to take your money for management fees…***
> ***We've taken the approach that if we do a good job of managing these portfolios and we're the largest shareholder in the funds, the performance will take care of South eastern's revenue growth – i.e., the funds will grow and happy shareholders will add more capital and eventually the word will get out and others will partner with us.***
>
> ***Mason Hawkins***
> ***Longleaf Partners***

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, 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". Our size is our great advantage.

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

Special thanks to my editor, Karen Molgaard, who keeps my opinions (quasi) politically correct, while ensuring our letters are understandable to all. I must admit Karen has been extra benevolent this past year by affording your fund manager a sliver of additional "grammatical slack". One is always treading a fine line when dealing with a "wordsmith" of Karens calibre. Also, special thanks to Kathleen Way who will be moving on to new challenges. We wish her all the best in her new position.

Candy Yu will be my new assistant. She has been working for us over the past year while completing her bachelor of commerce. I only wish I was half as efficient as Candy. She embodies the triple "E", meaning she is super "efficient", "effective" and "energetic" (of course after her morning coffee). Don't hesitate to call Candy for an update on your account (or on the latest hot club news in Montreal).

We do appreciate your **referrals** of qualified new fund investors. Next entry-date into the Value Contrarian Fund: March 29, 2006. Call today (514) 398-0808.

Respectfully Yours,**

Benjamin D. Horwood
February 26, 2007

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 period of negative returns or a year of underperformance. Unfortunately, human nature prefers the exact opposite.