VALUE CONTRARIAN ASSET MANAGEMENT

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2004 Year End
Value Contrarian Canadian Equity

Dear Investors,

> ***…The million dollar question remains, what happens to the income trust market when the attributes that created the "perfect storm" subside or disappear altogether?***
>
> ***Paul LeBreux***
> ***Tax Lawyer***

> ***You don't get smarter because you're running something called a "hedge fund" or something called "private equity" or something called an "LBO fund"…These are fads on Wall Street. And Wall Street will sell what it can sell…It's one of the most important things you should remember in investing. And the hedge fund right now is in the midst of being a huge fad…(Nonetheless) there are a few smart, honest people out there running hedge funds - and they will do quite well. But I'd say people now investing in hedge funds in aggregate are going to be disappointed.***
>
> ***Warren Buffet***
> ***Chairman Berkshire Hathaway***

Like "hedge funds", we would also offer up the opinion that over the next year many new investors to the Income Trust sector will be sorely disappointed. Bay Street bankers over the past 12 months have been busy manufacturing stock market listed income trust fund products, at an "assembly line" pace that would have made Henry Ford proud! In January of this year alone, investors shoveled $982 million into the trust and income sector, while yanking $698 million from Canadian equity funds.

Like hedge funds, the trust sector has become a "fad". As interest rates have declined over the past four years, sizzling hot trust returns have certainly benefited investors who were early to the sector. However, despite the sector gaining prominence during the mid to late 1990s, many retail investors have only seriously climbed aboard during the past 18 months.

With a one year risk free GIC recently yielding **1.65%**, and the five year equivalent yielding a paltry **3.5%,** income trusts (**a.k.a. high yield equities**) have been a quick fix to investor's prayers for higher fixed income returns.

Our worry is that investors don't fully understand that the high yield on many of these trusts will not immunize them from a bear market decline (ie: capital loss/distribution cuts). Just as the high yield on US high yield bond funds did not prevent major losses during the bear market of 2002.

Stock market history repeatedly demonstrates that when investors all pile into a particular sector that has performed well for many years (resulting in stretched valuations and higher risks), heartache eventually strikes.

Four consecutive years of unparalleled inflows of monies has led to overvaluation in the income trust sector. Many oil & gas trusts are, in our opinion, "Ponzi" schemes and "accidents waiting to happen". Rising oil prices have merely served to delay the day of reckoning.

Popularity has lead to 52 consecutive months of positive trust mutual fund inflows (October 2000 to January 2005). In fact, the last time the trust sector experienced an outflow of money was for 18 consecutive months, between April 1999 to September 2000. Interestingly, this coincided with a period of rising interest rates. Has Greenspan not already warned us to expect rising rates in 05?

When purchased wisely, there is nothing wrong with income trusts as a class of investments. As in any sector there are good/great companies along with the "riskier" merchandise. Riskier meaning those trusts which will not be able to sustain their current payout over an entire business cycle. We, in fact, over the past quarter have been investing in so called "busted" trusts. These are trusts where the distributions have been eliminated or cut in half. Advanced Fiber Technologies being one such case. We also own Yellow Pages and custom broker PBB Global Logistics. As with most of our investments, we prefer to own trusts which are superior quality businesses.

Perhaps the ultimate contrary indicator occurred this January when it was announced the S&P/TSX will later this year add income trusts into the composite 300 index.

The end to the income trust "feeding frenzy" will be based on simple principles. Rising interest rates (on 30 year bond yields), a good old fashion business recession and/or an unfavourable federal tax/budget change will eventually cause grief, especially to those investors late to the income trust game.

Own income trusts, but please understand their risks and be able to live with those risks during the inevitable tough times.

2004 Performance: +10.5%

January 1, 1997	—	$1,000.00 (inception NAVPS*)
December 31, 2004	—	$2,134.45 (NAVPS)
December 31, 2004	—	$66.97 distribution per unit
December 31, 2004	—	$2,067.47 (NAVPS after distributions)

Your fund ended the year with a net asset value of $2,067.47 per unit, after having declared a distribution on December 31, 2004 of $66.97 per unit.

Your distribution was reinvested in additional units. These new units appear on your December 31, 2004 Value Contrarian Statement.

Rising long-term interest rates during the first half of 2004 and fifty dollar+ oil were the two major outside factors restraining stock prices during much of 2004. Yet by year's end, the markets rallied smartly as the above negative factors began to moderate. Resource and interest sensitive stocks were big sector winners.

The most recent bear market bottomed in October of 2002, and valuations have risen to the point where the easy money has already been made. Cheap stocks remain in the minority, but individual opportunities always crop up (usually due to negative earning surprises).

Nobody is asking about Nortel or Bombardier anymore. Instead, the crowd's "greed" has turned to resource stocks and income trusts. As usual, investors feel more comfortable chasing the previous "winners" instead of looking for value. There is little investor "fear" in the air, a sign we find discomforting.

2004 can be characterized as a year in which we maintained and pruned the V/C Fund portfolio, as opposed to making large new bets on a particular stock or industry. As a result, your fund ended the year with a significant (27%) cash position.

Rising cash levels should not be viewed as a call on the markets direction, but rather a consequence of lofty stock valuations and our desire to control risk. And while earning 2% on short-term investments is no fun, we agree with Buffet that "…occasionally, successful investing requires inactivity." And lots of patience.

The IPO (initial public offering) market provided fertile ground for some quick profits at years end. Speculative froth was definitely in the air.

* Net Asset Value Per Share

For example, one of our holdings, Addenda Capital, a Montreal based bond fund manager went public in December at $18.00 (18X earnings), and quickly moved to $25.00 by months end. While Direct Cash Income Fund came out at $10.00, and was booted from the portfolio within days at $13.50. As we've often stated in the past, "don't confuse a bull market with genius".

Our "genius" quickly evaporated with the purchase of BCE Emergis, our biggest disappointment during the year. This was a statistically cheap stock with almost half its share price in cash. Unfortunately, a cheap stock became a lot cheaper when the investment dealers got stuck with unsold Emergis stock as a result of a botched bought deal.

In retrospect, the underlying business was not up to our (cash-cow) standards, while the risks of "growth through acquisitions" rests on a team with a spotty track record. We sold half our position at cost, and hope for a takeover as there is no controlling shareholder.

In concluding, our outlook is cautious. We suspect that over the next several years, on average, the markets will post positive returns from stocks, but below the historical 10% - 11% average.

In coming years our key to superior returns will be won by side stepping the worst of any future bear markets, while at the same time having the conviction to be aggressively buying during the inevitable periods of utter panic. Pass the Nexium* - please.

* Nexium – the blockbluster ulcer drug by Astra Zeneca

Healthcare Comments from a Baby Boomer

> ***It is ethically unacceptable for Canadian politicians to reject, out-of-hand, potentially better options simply out of adherence to a fixed ideology…All Canadians are entitled to all medically necessary health care and allows them timely access to that – but that does not necessary mean providing health care only through a public system..***
>
> ***Margaret Sommerville***
> ***McGill Centre***
> ***Medicine, Ethics and Law***

"Two-tiered" system, "queue jumping", "healthcare for the rich" – the liberal press and many Canadian politicians are fighting a losing battle over state monopoly medicine, and the reasons are simple. When it comes to their personal healthcare, middle class Canadians, when faced with waiting for a procedure/test, will increasingly demand "freedom of choice". The freedom, for example, to visit a private healthcare clinic. The freedom to use their after tax savings on healthcare or however they see fit. Why is it that Canadians are allowed to freely spend their after tax dollars on alcohol, cigarettes or lottery tickets, but in most provinces are unable to purchase an MRI or CT scan?

The middle class fully supports the state providing certain basic services. These include, for example, not only medicare, but public bus/subway service and public subsidized housing. Nonetheless, the state does not prevent the middle class from the freedom to choose (acquire) a private vehicle, instead of the bus, a single family home in the suburbs, instead of cramped public housing, or a stay at a Holiday Inn, rather than camping in a Provincial National Park.

Life in Canada is not a "two-tiered" system, it's a "multi-tiered" system – welcome to the Western world. If one wants to see how "perfect equality" works one can hop on a plane and visit a Marxist beach paradise called Cuba. Middle class Canadians are increasingly demanding the choice of private healthcare when the state can't or won't provide the timely service they desire. And as the baby boomers age, the already swamped state system will be further short circuited.

Luckily for your portfolio manager, Quebec (perhaps more out of economic necessity, than ideological convictions) has been in the vanguard of permitting private healthcare options.

On a personal note, my hat goes off to Dr. Jeff (Chunky) Chankowsky and his 25 partners who four years ago set-up the state of the art Westmount Square Medical Imagining Clinic in Montreal.

Over the recent holiday period my GP ordered a variety of stomach tests. Despite my condition not appearing critical on the surface, I wanted answers right away, not next month or in six months. Within seven days, I had an appointment and complete test results at Dr Chankowsky's Clinic. I was more than willing to pay $150 for this prompt service. The Montreal clinic provides a host of medical services, including MRI & CT scans, ultrasounds, and general diagnostic x-rays.

Most refreshing were the customer service touches, such as free underground parking for clinic patients. Even former PM Chrétien would likely agree this "Westmount" Clinic was not about "small town cheap". Good client service and healthcare service need not always be an oxymoron.

In concluding, if the British and French can figure out how to live with both a state and private healthcare system side by side, it's very likely Canadians can do the same. The writing is on the wall for Canada's "one size fits all" monopoly medical system. Politicians who ignore the middle class do so at their own peril.

Wildcard Surprises for 2005

1. **Oil Shock** – Global oil disruption: Venezuela/Nigeria/Russia/etc…

2. **Interest Rate Shock** – Unexpected rise in long bond yields

3. **Financial Crisis** – Derivatives/Hedgefunds/Banking/U.S. Currency

4. **China/Taiwan Conflict** or **China Internal Civil Strife**

5. **Middle East Conflagration** – Oil supply disruption/Economic fallout (Iran/Israel – Saudi Arabia turmoil – Lebanon/Syria – Iraqi Civil War)

2005 Outlook

> ***The Dow went from 66 to 10,000+ during the 100 years of the 20th century. And we had two world wars, nuclear bombs, flu epidemics, the Cold War – you name it. There will always be problems – and there will always be opportunities in the future. But in this country the opportunities have won out over the problems over time.***
>
> ***Warren Buffet***
> ***Chairman Berkshire Hathaway***

Well, we were wrong last year on our interest rate assumptions. But then again, so was a lot of "smart" money, including Alan Greenspan. He recently admitted being baffled as to why long-term interest rates (30 year bonds) continued to tumble, even as the U.S. central bank ratcheted up short-term rates.

In the past what usually occurred, was a rise in short term rates coincided with a rise in long-term rates. Instead, rising short rates have been offset by falling long rates. As a result, the fed tightening cycle may have been less effective this time (higher long term rates help slow the economy). This could translate into a longer and larger than expected period of rate hikes.

Over the past year a main beneficiary of this drop in long rates have been bank stocks and yield sensitive income trusts. Unfortunately, long bond yields can't fall forever, and that's what the "smart" money (besides Mr. Greenspan) is telling us again this year. Thus in early January, Warren Buffett, issued $3.75 billion of debt for one of his companies. Obviously, Buffet anticipates higher short and long term rates coming down the pipe and was keen to borrow at a time he could lock in low rates.

The problem with long periods of low interest rates is that asset values (stocks/bonds/real-estate) become inflated and investors engage in excessive risk taking. Today no major asset class is cheap. Thus our biggest worry is more about conserving capital, than making capital.

Both Greenspan and Dodge have put investors on notice (remember his December 1996 irrational exuberance warning) that short-term rates will be rising during the coming year. The unknown is how much will long bond yields rise. The higher they rise, the more potential for damage to stock prices.

Oil prices should continue to remain robust ($40+) throughout the year. Although not anticipated, a major slowdown in China, would be a catalyst for significantly lower energy prices.

2005 will be another year for those with good stock picking skills. **If** long term interest rates remain at or near present yields (4.6% - 5.0%), and there are no oil shocks, we see positive single digit stock returns for the coming year.

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 the better performing funds, even if that means limiting the Funds 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 club, 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 actually makes all of our investment letters readable. And also a special thanks to Kathleen Way, my cheerful assistant (how does she do it?) who has to deal with my "Type A" personality on a daily basis!

We do appreciate your **referrals** of qualified new fund investors. Next entry-date into the Value Contrarian Fund: March 31, 2005. Call today (514) 398-0808

Respectfully Yours,**

Benjamin D. Horwood
Portfolio Manager
March 1, 2005

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.