2012 Second Quarter
Value Contrarian Equity Fund

Dear Partners,

In a democracy, politicians don't usually make difficult pre-emptive decisions (think: euro crisis or sub-prime mortgages). It often takes a gut-wrenching crisis to get things done. At the onset of the crisis the financial markets will often lead/be ahead of the politicians. Eventually, enough financial pain is endured (e.g., bear market) that forces decisive action.

Benjamin D. Horwood
August 1, 2012

My own working assumption is that the Europeans are learning the hard way that to run a single currency, you have to have not only a monetary union but also effective governance of the economic union.

Jean-Claude Trichet
Past President
European Central Bank

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In May, Value Contrarian Asset Management (VCAM) underwent one of its regular AMF (securities regulatory) working capital audits. Simply stated, financial audits are a constant in our business. Below is the audit breakdown over the 2011-2012 period to date:

1) VCAM Audit: August 31/2011 year-end
(Schwartz Levitzky Auditors - Annually)

2) Value Contrarian Fund Audit: December 31/2011 year-end
(Deloitte Touche Auditors - Annually)

3) VCAM Working Capital Audit: May 7/2012 (random audit)
(AMF audit staff – every 2-5 years)

Many of our partners/investors don't fully realize the degree of regulatory oversight involved in running a financial services firm like VCAM and the V/C Fund. I don't wake up any more dreaming of "college girls gone wild" but rather of "regulators gone wild"!! Quebec tax payers don't have to worry about footing the cost of an AMF audit; rather VCAM must pay for this priviledge ($88 per hour).

On the positive side, the post Vincent Lacroix, Earl Jones, Bernie Madoff world has resulted in significant new regulatory barriers to entry into the money-management business. Nonetheless, no matter how hard they try, governments and regulators can't outlaw fraudulent behaviour. There will always be unethical individuals who operate outside the laws, outside the rules, and thus can't be stopped without a dose of personal investor responsibility and common sense. We have always noticed that the common trait of these fraudsters is a "charming" personality. Be wary if Ben starts to assume a charming persona! Remember, crotchety is highly underrated.

At a recent Quebec AMF educational conference on the expanded rules and regulations for money management firms, the audience responded with a good chuckle when I asked if the new laws contain a "free get out of jail pass" for long-term good behaviour on the part of a money management firm. Looks like VCAM's twenty years of good behaviour does not count for much in this new environment.

Unfortunately, a few rotten apples have "tarred and feathered" the entire industry. Thus, the next time we ask you to sign that same investment form for the 10th time, please have patience. Constant client updates (every 2 years) are required by the regulators (it's for your own protection).

Second Quarter Performance

> **Extraordinary low yield levels cannot meet**
> **the long-term return expectations for anyone.**
>
> **Larry Fink, Chief Executive**
> **BlackRock**

Your Fund ended the second quarter with a net asset value of $2,418.69 per unit, an increase of $113.51 from the December 31,2011 net asset value of $2,305.18 per unit (after distributions). Year-to-date six month performance : + 4.9%. The TSX performance during this period: - (1.5%).

With record low fixed-income yields, investors are grasping for higher returns. Real yields (after inflation) are in negative territory. For example, a taxable U.S. investor who buys a 10 year Treasury bond (yield 1.5%) pays approximately 40% to Uncle Sam in taxes. The after tax yield is thus 0.9%. With the inflation rate at 2%, an investor is receiving a rather large negative return. Real yields have been negative before in the 1970s. During that period investors were caught out by a sudden surge in global inflation and were too slow to push yields higher in response (until the early 1980s).

Today, chasing income (e.g., pipelines, telcos, reits, utilities, trusts) raises the risk that investors are <u>piling into crowded (expensive) trades</u>. Recent gains could easily be reversed when interest rates eventually rise. According to a recent Barclay's Capital study, history suggests that investing at the current low level of U.S. Treasury yields (10yr. 1.55%, 30yr. 2.45%) is a very bad option. Investors who bought Treasury bonds at a 2% yield in 1945 earned a <u>negative</u> real annual return of 2.3% over the subsequent 35 years.

My guess is that it will take some type of <u>geo-political event</u> (think war) to kick-start a long term secular rise in interest rates. Whether in six months or six years from now, rising rates will eventually catch most investors by surprise.

Negative market returns during the quarter, and the failed merger with Deutsche Bourse, enabled your manager to ramp up the purchase of shares in the New York Stock Exchange at a discounted price. Second quarter market declines also created opportunities to add to our existing holdings in money manager BlackRock and Berkshire Hathaway.

The Canadian market has been in negative territory for most of the year based on the dismal performance of trees, rocks and oil. The slowing Chinese and Indian economies demonstrate that these two global growth engines are still subject to the business cycle. Moreover, they are not guarantors of peak prices for Canadian resources.

Investors have been mesmerized by the crisis headlines coming out of Europe without realizing that only 6% of U.S. exports are destined for this trading bloc. Nonetheless, it is <u>a sign of the weakness in the global economy that central banks have forced interest rates to their lowest levels in history.</u>

In this environment our goal is simple to continue to hit singles and doubles and be happy with the occasional walk. With risk-free GICs returning 1% - 2.5%, a 5% - 7% annual return is not too shabby. One will have to accept volatile financial markets in order to participate in these equity returns. Unfortunately, <u>investors wrongly equate volatility with increased investment risk</u>. <u>Overpaying or technological change is what really creates equity risk</u>.

OUTLOOK

The latest [June 29th] plan has only brought the eurozone a bit more time to sort out the longer-term <u>structural</u> woes.

Larry Summers
Former U.S. Treasury Secretary

It [the euro] could only work if the euro zone entered a <u>fiscal</u> and <u>political</u> union, which won't happen, as Europeans aren't prepared to give up their national sovereignty. Politicians therefore will go from one compromise and quick fix to the next, with the crisis deepening until some nations at the periphery won't be able to stand the economic pain anymore [and exit].

Felix Zulauf
Zulauf Asset Management

Angela Merkel, the German Chancellor, has clearly stated the ultimate solution to the ongoing euro crisis. The key is not for Germany to guarantee the debts of its weaker euro partners but rather to agree on sweeping new rules towards a "... complete economic and monetary union". Ultimately, the financial markets will force the politicians' hands. There is now a race going on between the <u>eurozone policy makers</u> and the <u>financial markets</u>. With 17 parties sitting at the table, the decision-making process will at times seem glacial in pace.

Our "<u>best guess</u>" is that it will take another <u>market meltdown/deep recession</u> (think crisis) for eurozone politicians to finally agree to the necessary fiscal and political solutions to resolve the fundamental flaw of having one single eurozone currency (and one restricted central bank-the ECB) tied to <u>17 different countries</u>. (Each with their own national outlook: A. prudent or B. extravagant/reckless in respect to their spending-borrowing-taxing habits.)

The next global bear market will create a once in a decade buying opportunity in European securities. Here is our potential shopping list:

1) European junk bonds/senior bank debt (''too big to fail institutions")
2) European small caps
3) European blue chip ETFs (exchange traded funds)

Over the next few years we will be witnessing an ongoing game of financial "chicken" by the Germans, who want to use the current crisis to force reforms on their southern European neighbours that wouldn't be possible in normal times.

Respectfully yours,

Benjamin D. Horwood
Portfolio Manager
August 1st, 2012

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 Fund?" 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.