2004 Third Quarter
Value Contrarian Canadian Equity

Dear Investors,

> ***This is one of those very rare times in which most long-term (investment) assets are generously priced…One of the major reasons why is that the Fed fund's rate of 1.5% has made it extremely difficult, even painful, to hold short-term funds (cash)…As a result, the compulsion is to think, "Well, therefore, I have to buy something else (instead of preserving capital with cash).***
>
> ***James Gipson***
> ***Clipper Funds***

> ***In the Bible, it says that love covers a multitude of sins… For human beings, there is no substitute for love. For (equity) investors, there is no substitute for <u>paying the right price</u> – absolutely none. You've got to buy things at the <u>right price</u>. If you don't, you're not going to make money (whether it's a blue chip stock or not). It's just that simple.***
>
> ***A. Van DenBerg***
> ***Century Management***

Most forecasts are wrong and rarely more so than in the <u>oil markets</u>. For the last four years prices have turned out higher than expected. Spare production capacity within OPEC is anywhere from zero to 1.5 million barrels per day, depending on which official is speaking.

We would agree with the assessment that <u>rising demand</u> within a global oil system running at <u>full capacity</u>, rather than a disruption of supply, underpins the current high crude price. Unlike the crude-price increases that followed the oil embargo in 1973, the Iranian revolution of the late 1970s, and the run-up to the first Gulf War, the basis for the current jump is not the result of a fall off in supply but on <u>increased global demand</u>.

Booming economies in China, India and the United States have accounted for most of the increased oil consumption this year. Simply stated, any system running at near full capacity is prone to volatility and high prices – including the oil markets.

Unfortunately, outside of the Middle-East, significant new energy supplies cannot occur in a short period. For example, an Alberta Oil Sands project requires a 3-5 year development period and there is always the potential for huge cost overruns.

Presently, the futures markets are starting to tell us that high oil prices may persist longer than many experts believe. For example, future contracts for oil to be delivered in 2010 are trading now at $34.30 a barrel, or one-third more than when they began trading in March. Obviously that would put a damper on consumer spending while cutting into corporate profit margins.

Our gut feel is that going into 2005, disappointing profit growth (excluding commodities) will be on the rise. Yet, for whatever its worth, the International Monetary Fund still sees robust world economic growth next year (above 4.0%), despite high oil prices. If that is true, than this past summers drop in bond yields could be short lived, with higher rates just around the corner. (Remember, higher economic growth often leads to higher interest rates – which are not good for bond prices).

Finally, if it makes one feel any better when filling up your SUV, the "half full crystal ball crowd" hopes to lessen the pump pain by pointing out that crude oil prices remain far lower "adjusted for inflation" than during the oil shocks of the 1970's. Nonetheless, for some "strange" reason, SUV sales have started to stall. Perhaps the "adjusted for inflation" oil price (ain't really expensive) argument is not as painless as it sounds. Bottom line, a fifty dollar plus gas fill-up is a painful expense no matter how it's "adjusted for inflation" !

Third Quarter Performance

Your fund ended the third quarter with a net asset value of $2,022.97 per unit, an increase of $91.98 from the December 31, 2003 asset value of $1,930.99 per unit.

Excluding oil and commodities, the third quarter was not kind to most stocks. However, falling long-term interest rates revived the trust and income fund sector. An opportunity arose for your fund when Bell Canada sold off its remaining stake in the Yellow Page Income trust and we again bought the issue.

We have successfully bought and sold this trust on a number of occasions (depending upon valuations), and feel very comfortable with its stable business model and potential for small but steady distribution increases.

Investors must not forget that the juicy 11% - 12% yields on income funds are not guaranteed. Most importantly, the sustainability of distributions to unitholders is paramount as many investors are purchasing these securities as a source of regular income. In general, they should be "good", "non-cyclical" types of businesses.

We prefer those trusts that focus on conservative payout ratios. The "trust" structure imposes on management the discipline to pay out most of the cash flow generated. But as one veteran manager points out, "this should be balanced with a safety margin that comes with a conservative payout ratio." For example, a company that has one dollar of distributable cash flow and also pays a dollar dividend is not leaving any margin of safety.

On the whole, a recent study of business trusts by brokerage firm Raymond James showed that 45% of these trusts have increased distributions, 40.6% maintained distributions, while 14.4% have decreased or eliminated all distributions. The latter statistic is a painful reminder that investors need to do their homework in the trust arena, as many are not really stable businesses with stable distributions. The next major business recession will likely further expose income trusts into categories of the "good", the "bad" and "help".

With respect to individual stocks in our portfolio, we sold our entire position in Goodfellow Lumber after a holding period of approximately ten years. Although not a block buster performer, our investment increased in value by 5X over the period.

Goodfellow is in a cyclical business. With the price of lumber reaching record historical highs during the September hurricane season, we opted to sell into strength. This is a small-cap illiquid stock which may revisit our portfolio if it were to again fall well below its book value.

We also received a disappointing take-over offer for our Molson's shares. We had been anticipating further bad results from their Brazilian operations. This would have given us the opportunity to increase our position (we like to buy on bad news). Instead, a "merger of equals" offer from Coors suddenly appeared. Beyond some potential cost savings, the rationale for the takeover is not strong and has encountered stiff opposition from prominent shareholders. The "merger" appears to be more about maintaining a family beer dynasty than maximizing value for shareholders.

Royal Bank and TD Bank, two large positions we hold, have also been in the news of late. TD's proposed 51% purchase of Banknorth looks like a brilliant "acceptable risk" to enter the U.S. banking market. The key point being that TD's Ed Clarke didn't just buy a dominant New England bank, he bought America management with a proven track record to maintain and grow this investment. It will be the Americans running the show, management which fully understands the local market.

Unfortunately, the Royal Bank has been suffering indigestion over the past year from its $8 billion investment foray into the American market. Moreover, Centura, the Royal's North Carolina Bank does not have a dominant market share in its market, nor did it come with a crackerjack management team.

With respect to Centura, in our opinion there are two solutions which would make Royal's Gord Nixon look like a hero:

a) Sell Centura at a nice premium and initiate a significant stock buy back, while leaving enough dry powder for a second run into the American market at a later date.

b) Get big or go home. Sell Centura to a high quality large dominant bank in the south-east such as Sun Trust. In return, Royal would receive no cash but a significant ownership position in the shares of Sun Trust. Royal would obviously have to negotiate an agreement to further enlarge its stake in Sun Trust at a later date. Royal would let Sun management run the American show and in the process Sun would thus be able to maintain its independence and prevent any unwanted takeovers from U.S. suitors.

We continue to maintain large cash reserves in the fund's portfolio. Cash has risen as a result of both new investors and stock disposals throughout the year. While everybody hates cash, when there are limited opportunities at the right price cash can be the best investment – it's certainly better than losing money!

Outlook

> ***We can't go through the whole industry cycle of exploration, development and production quickly enough to dent oil prices in the short term …The time for large and easy discoveries is clearly behind us..***
>
> ***Thierry Desmarest***
> ***CEO Total Petroteum***

Demand for oil is expected to remain strong through next year, while geopolitical risks (Iran, Nigeria, Saudi Arabia, etc…) are unlikely to go away. But many would obviously like to know how long will oil prices remain high.

Interestingly, BP's Lord Browne and Exxons CEO Lee Raymond are not prepared (for now) to say that there is a structural shift upwards in oil prices.

According to Mr. Raymond: "For those that have been around for a long time…you look at the words that were written at the time, saying that there was a fundamental shift in the energy demand and then the price collapsed. It has yet to be seen as this cycle plays out if there is a fundamental shift".

There is really no way to accurately predict the direction of oil prices. If fears of a disruption in supply keep speculators buying, the high price of energy will hold back the US economy and the equity markets.

Tell us where the price of oil is headed and we will tell you the direction of the stock markets. In a nutshell, oil speculatively going higher is one of the biggest risks to the financial markets. Conversely, falling crude prices would create positive opportunities for equities.

We see no reason to alter our cautious stance. And while we may lag the index on the upside, capital preservation continues to be foremost in our minds.

Respectfully Yours,**

Benjamin D. Horwood
Portfolio Manager
October 15, 2004

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.