## 2001 Year-End
## Value Contrarian Canadian Equity

Dear Investors,

> ***The one thing I can never understand… I'm going to buy hamburgers the rest of my life. When hamburgers go down in price, we sing the "Hallelujah Chorus"…When hamburgers go up (in price), we weep. For most people, it's the same way with everything in life they will be buying – except stocks. When stocks go down and you can get more for your money, people don't like them anymore.***
>
> ***Warren Buffet***
> ***Berkshire Hathaway***

> ***It takes guts to be a great investor. It takes an analytical mind, and ability to size up managements…. But most of all it takes guts. It takes guts to believe that you're right when the market is saying you're wrong. And it takes guts to buy when everyone else is selling.***
>
> ***William Green***
> ***Financial Journalist***

2001 was a tough year for investors – so tough in fact that Berkshire Hathaway, Warren Buffets investment vehicle, saw its book value fall for the first time in its 37-year history.

2001 witnessed the continuation of the bursting of the tech and telelcom bubble. The bear market sell-off reached its zenith on September 21 as recessionary and war uncertainties gripped the North American financial markets.

We are happy to report that all of our clients stayed the course during this extremely turbulent period. Congratulations!! Unfortunately, many investors suffered permanent loss of capital after departing from sound investment principles during the "speculative mania" of the late 1990's.

During the coming year we see the markets being engaged in a constant " see-saw" battle. As good economic news trickles in investors will cause stock prices to soar far ahead of actual business fundamentals. This in turn will lead to volatility and sharp drops in equity markets, as profit expectations are not immediately met, or profit disappointments occur.

## Income Fund "Bubble"?

Investor's appetite for high yielding income products seems insatiable, especially in light of the miniscule interest rates being offered on GIC's and T-bills. All we can say is "buyer beware" of the looming debacle.

Low interest rates are encouraging investors to take the " fixed-income" portion of their portfolio and allocate it into higher yielding investments. There is nothing wrong with such a move, as long as one has a properly diversified portfolio, while fully understanding the risks involved in these products.

Over the past two months Canadian brokerage firms have happily produced over half a billion dollars of high income product for retail investors. As was the case in the late 1990's (e.g. Rogers Sugar, Westshore, etc…), many investors are eventually going to be hurt by these products for two reasons: 1) interest rate risk; and 2) business risk.

As the economy heats up and employment rates stabilize, Mr. Greenspan will once again be taking the punch away from the punch bowl in the form of higher interest rates.

Although we don't have an interest rate "crystal ball", we wouldn't be surprised if interest rates started to rise six to twelve months from now. Many investors are forgetting that income funds are highly sensitive to rising rates and can easily drop by 15%-20% in value.

Monthly distributions of income funds are not guaranteed like a government bond or a GIC. Business setbacks including loss of customers, strikes, higher than expected capital expenditures, etc, will also have the potential to reduce the juicy 11%-12% yields being advertised for many of these funds.

However, income funds do have a place in an investor's portfolio, provided they are chosen with a careful eye with respect to the quality of the underlying business, future growth prospects, and the price being paid. Unfortunately, by flooding the market with these "hot" income investments, Canadian brokerage firms (as in the past) will eventually kill the goose that layed the golden egg.

For the record, your fund has recently taken profits in two income funds (Atlas Cold Storage and Livingston International), while purchasing shares in Advanced Fiber Technologies Income Fund.

## 2001 Performance: +7.2%

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|---|---|---|
| January 1, 1997 | — | $1,000.00 (inception NAVPS*) |
| December 31, 2001 | — | $1,740.30 |
| December 31, 2001 | — | $ 0 distribution |
| December 31, 2001 | — | $1,740.30 (NAVPS after distributions) |

Your fund ended the year with a net asset value of $1,740.30 per unit. No distributions were issued for the year 2001.

During the past year our "old economy" stocks served us well in light of the extreme volatility in the financial markets.

We bet that the events of September 11 would trigger a bottom in the markets as a result of the convergence of three key elements:
1) a global political/economic crisis; 2) confirmation of a recession; and
3) declines of 20%+ on the major stock index's

Simply stated, <u>the worst of times are the best of times to be buying equities</u>. By the end of 2001 we were down to a 5% cash position and <u>today we are fully invested</u>. We have not been fully invested in the Value Contrarian Fund since the early 1990's.

The uncertainties created by the events of September 11, afforded <u>once in a decade buying opportunities for your fund manager</u>.

Although we are not " theme" investors, we continue to believe that the next decade and beyond will be dominated by <u>drug & health care issues/ opportunities</u>. This will be an area of profitable growth, as opposed to growth for growth's sake.

One of the biggest mistakes investors make is when they become <u>mesmerized by the sales growth potential</u> of a company, industry or sector. Yet, as we have seen from the dot com/tech debacle, at the end of the day it's <u>profitable growth</u> that counts, not just <u>sales growth</u>. Amazon.com has amazing sales growth but no real profits; while Microsoft was profitable from day one. Show me the beef, show me the profits!

During 2001, we continued to increase our fund holdings in foreign companies, primarily in U.S. pharmaceutical and financial stocks.

In early December 2001, Merck, a major pharmaceutical company announced that its profits for 2002 would be unchanged from the prior year. For a company that regularly showered investors with double digit profit growth this was a major disappointment. Consequently, the shares we feel were unfairly punished.

* Net Asset Value Per Share

While it is true that the company faces patent expiration and stiff generic competition, the negative outlook for the next year or two enabled us to purchase shares of a world class drug company at 18.5X earnings.

Earning's disappointments and other negative corporate surprises continue to provide buying opportunities for your fund manager.

Recently, after the Nikkei hit 18year lows, we added 20,000 shares of the Fidelity Japan Value Fund. This fund trades on the London stock exchange. Though this vehicle, we purchased a portfolio of battered Japanese stocks at a further 16% discount from the underlying value of the portfolio. This is Contrarian investing at its best!

Our mistakes during 2001 were small but nonetheless embarrassing! We tried our hand at making some money in Nortel and other telecom stocks, and were duly flogged for our stupidity. (Do not even think about buying shares in Nortel until the stock price is well under 1X sales. But will sales be $18 or $16 or $13 billion?)

We continue to find pockets of value in the market, especially in the small cap stock area, and look forward to updating our investors in the next quarterly investment letter.

## The Year Ahead – 2002

> ***Well, 25 years of a bull market with the S&P returning 15-18% per year seems to me like too much of a good thing. So maybe stock markets will have to spend two, four, six or even 10 years working their way sideways. And that's not because those companies won't be doing well…..it's just that the business values of those companies need to grow up into their stock prices. …This may be a period of low-to-mid single digit returns over the next five or 10 years.***
>
> ***Wally Weitz***
> ***Weitz Partners***

There is no question whether we're going to get a recovery. The tough question is predicting its strength. Simply stated, the forces of massive liquidity and 40-year low interest rates have empowered consumer spending thus preventing the recession from taking on an ugly tone. Record home sales as a result of record low mortgage rates, combined with resilient auto sales, have prevented the economy from sliding into a deep recession. Falling gas and petroleum prices have also enabled North American consumers to maintain their spending habits.

Unfortunately, this means potential pent-up consumer demand is not available to ignite a dramatic economic recovery. Consumer spending didn't slow during the current recession as much as it had in previous slumps.

Just as business contraction created the recession, it will be business investment that will lead to the recovery. The strength and durability of the recovery will be driven by how rapidly business investment picks up, combined with continued consumer spending.

No matter how low interest rates fall, Nortel won't be expanding its fiber optic capacity anytime soon, nor will North American auto manufactures be rushing to build new plant capacity. Businesses are burdened with overcapacity.

Words best used to describe the recovery of 2002 could well be slow, gradual, or muted. (The minority or contrarian view sees strong economic growth in 2002.)

Going forward, investors must reduce their expectations vis-a-vis stock market returns (see next page quote). High valuations in the general stock indexes will dampen future returns. The wind will no longer be blowing in investors favour in the form of the dramatically falling interest rates of the past twenty years or a generally undervalued stock market. Stock-picking skills will now be paramount.

The long bull market that led so many investors to believe in their own stellar financial acumen is over. Nonetheless, there will always be pockets of good value. A stumble, a misstep, a product failure/delay, or a similar negative scenario is what often creates value investments for your manager.

As for the broad stock-market indexes in 2002, as long as interest rates don't rise, we could 7%-10% gains for the year. The wildcards in 2002 – rising interest rates, and Bush's phase II anti terror campaign.

## Management Note

> ***I think stocks are a perfectly decent way to make 6-7% per year over the next 15 or 20 years. But I think anybody who expects to make 15% per year – or expects their broker or investment advisor to make that kind of money – is living in a dream world.***
>
> ***Warren Buffet***
> ***2001 Annual Meeting***
> ***Berkshire Hathaway***

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. Our goal is to keep permanent loss of capital to a minimum, the upside will take care of itself.

Being the 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 their continued support during the past year.

Respectfully Yours,**

Benjamin D. Horwood
March 1, 2002

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.