

1999 First Quarter Value Contrarian Canadian Equity

Dear Investors,

"Mutual-fund managers desperate to put cash to work, don't buy what is cheap but what is working, since what is cheap by definition hasn't been working.

... So long as there are inflows into the hands of institutional investors, there will be a telescoping of investment into the several dozen names that have reliably reported quarter-by-quarter earnings growth and almost constant share price appreciation. This is actually a slippery and very dangerous slope. When stocks are rising for no better reason than that they have risen, the greater fool (theory) is at work."

**Seth Klarman
Baupost Group
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Short-term (as opposed to long-term) success in the money management business depends on style - what's in and what's out. When a firm's style is "in", they are often perceived as the sharpest managers around. When a firm's style is "out", they are often perceived as lacking the "right stuff". Historically, the market shows defined periods of outperformance and underperformance for given investment styles: value and growth, small-cap and large-cap. The dream is to find a manager who is always invested in the right style at the right time.

Today, many are chasing large-cap growth stocks primarily because they have been "winners" and are "moving up". This is not a sound investment philosophy over the long run. Making investment decisions without regard to price or value is like playing a game of musical chairs - it's great fun while the party momentum lasts, but can leave investors with an unpleasant hangover, especially when the music eventually stops.

1999 is turning into a repeat of 1998. More specifically, we have the continuation of a two-tiered market. This means there is strength in only a small number of stocks. These favoured few, big capitalization growth stocks heavily influence the stock market averages - all the while masking softness in the mass of (second tier) stocks.

For example, there are 500 stocks in the S&P Index. According to Barron's, one stock, Microsoft provided approximately a quarter of the returns to the Index so far in 1999 (end of March period).

One must remember that the TSE and S&P Index's are market weighted. The bigger the total value of the company, the more it will affect the Index. If Microsoft, Cisco, and Dell go up, an awful lot of stocks can go down and the market can still be ahead. In 1998, according to market researcher Laszlo Birinyi, 50% of the gain in the S&P 500 was in just 13 stocks.

Investors in today's market have in particular gone "ga-ga" over large-cap technology/ internet companies. Who can say that Amazon.com - which has never made a profit - is worth more than the Bank of Nova Scotia (1998 profits - \$1.34 billion)? America Online is now worth more than Walt Disney, Viacom, and CBS combined! The latest stampede reflects an attempt by many institutional investors who missed out on the stock market's big internet wave since the end of last year to make up for lost time.

Investing in large-cap growth stocks does make sense as long as one is buying in at reasonable valuation levels. Buying growth at any cost is what's particularly dangerous in today's overheated markets. More to the point, there is a great danger that the potential future earnings of the favoured large-cap growth stocks can't justify today's stock prices.

As an example, one need look no further than a well-known global beverage company that is supposedly much less immune to the business cycle, yet whose stock price has dropped drastically since last summer (\$89 to \$59). Simply stated, its stock price could not justify its earnings prospects.

Coke is one of the world's great companies and sells one of the most affordable consumer products; yet in 1998 its profits started to feel the pinch of the global recession and earnings fell to \$1.42 from \$1.62 in 1997. At its peak stock price of \$88.90, Coke was trading at 62x earnings. Despite Coke's good long-term growth prospects, there is no room for slowing sales or heaven forbid lower profits on a high P/E growth stock. (Today, Coke's P/E ratio is 42 and dropping.)

The next recession in North America will likely arbitrate (in an unfavourable fashion) the questionable valuations being placed on today's select group of high flyers. As one astute market observer recently commented in his annual report: "The speculative juices are flowing freely in the U.S. but the music will stop and many investors (speculators!) will not have any chairs to sit on. Caveat emptor!"

Classic "C.O.N.T.R.A.R.I.A.N."

"One of the safer times to invest is when the news is awful and markets are depressed. Such moments are often described as "the worst in 50 years"... The market recovery usually starts well before the turn around whatever the politico-economic situation that has made everybody tremble. As we say on Wall Street: "By the time the smoke has lifted, the train has left the station.""

**John Train
Montrose Advisors**

Being a "contrarian" means looking for investments that are currently not popular due to negative perceptions, usually resulting from a temporary setback. Obviously contrarians view these investments not as "dogs" but rather as "diamonds in the rough". A major risk that contrarian investors face is timing, being too early to the party and then watching a good value drop to an even bigger bargain (a most frustrating hazard of the profession).

Over the past three to six month period, your fund has participated in two classic contrarian investment situations - small-cap Japanese stocks and blue chip Canadian oil stocks. Here is our rationale on Japan.

From 39,000 in December of 1989, the Nikkei stock index plummeted to just under 13,000 in October 1998. Many sucker rallies occurred during this period, raising many false hopes of a recovery.

By last October, the two necessary ingredients came together in Japan signaling a market bottom - the combination of a severe recession with a 20%+ bear market decline. Despite the dramatic (60%) fall in the Nikkei since 1989 and all the negative news coming out of the country, during the 1990's the Japanese economy had not suffered a major recession until last year. In 1998, Japan experienced the first decline in the country's Gross Domestic Product in over 50 years (-2.7%).

Contrarian investors realize that one of the most opportune times to invest in equities (i.e.: best bargains available) is during a financial crisis which results in a recession - bear market combo. The Japan of last fall was a classic example of contrarian investing. Ben Graham value stocks were in plentiful supply and thus could be bought for less than the companies' net working capital.

One should not expect any quick fixes in Japan. But Japanese companies are finally biting the bullet and starting to restructure. This should lead to improved profitability, although it will take many years and higher unemployment. Finally, the worst of the banking crisis is over and the problems of the banking system are being tackled.

Unfortunately, today many investors are caught in rampant speculative excesses, while ignoring the fact that the train left the Wall and Bay Street stations nine years ago. In Tokyo, the train departed a mere six months ago!

First Quarter Performance

Your fund ended the first quarter of 1999 with a net asset value of \$1,383.08 per unit, a decrease of \$33.40 from the December 31, 1998 asset value of \$1,416.48.

Despite four of our top five Canadian equity holdings producing record profits in their latest financial reporting period, only one of the stocks was ahead for the quarter. During the quarter, rising long-term (30-yr.) interest rates negatively affected our bank stocks.

Spain, Italy, and now France are all participating in a massive consolidation of their top banks in order to more effectively compete on a local and international level. Unfortunately, the large Canadian banks won't be given such opportunities until after the

next federal election. With low price earnings ratios, inferior market capitalizations, and a weak currency, the Canadian government is dooming our banks to eventual foreign (American/ European) control.

Presently our cash, bond, and preferred share holdings represent 32.5% of the fund's assets. Going forward we intend to "stick to our knitting" even if that means accumulating a rising cash position. Being contrarians, we view market volatility and disappointments in company earnings as potential opportunities.

Outlook

Although the American markets are making daily climbs to record levels, the TSE 300 Index remains well below its last April peak of 7822. Moreover, most of the gains in the Canadian market are coming from a small number of large-cap stocks. This two-tiered market has created significant values in the secondary market amongst small and medium size Canadian companies.

Management's frustration at seeing their stock price languish at undervalued levels has resulted in the recent announcement of numerous stock buyback programs (i.e.: Perkins, Westburne, Rolland, Uni-Select, Alliance, Kingsway, Goodfellow).

The 1990's bull market rally has been characterized by two key elements: rising corporate earnings and falling long-term bond yields, with declining yields becoming the more important factor of late. As long as long bond yields are falling, the market remains much less vulnerable to a general selloff.

From recent experience, it appears that when long bond yields rise above 5.5%, equity markets react negatively. Conversely, when yields drop below 5.1%, the markets inflate upwards. For the next 6 - 12 month period, the direction of long bond yields will have a large impact on the fate (direction) of the stock markets. With the recent easing by the European central bank (50 basis points), the U.S. Feds on hold, and the drop in Canadian rates - the trend for 1999 is still positive. Good news for the stock markets - for now.

We continue to view the speculative behaviour of individual investors with great apprehension. We see many Canadian investors chasing certain stocks because they are "working", "going up", or a way to "play the internet". This strategy of backing today's "winners" (the "stock de jour") late in the business cycle will eventually cause a lot of pain.

Respectfully Yours,

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