VALUE CONTRARIAN ASSET MANAGEMENT

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2006 Third Quarter
Value Contrarian Canadian Equity

Dear Investors,

> ***I'm sure that all of you know highly intelligent people do foolish things. It's because the voice of intelligence gets drowned out by fear and greed… emotions that dominate participants in the stock market. So people acting as a herd, do some very foolish things because of emotions that block out reason and intelligence…***
>
> ***Arnold Van Den Berg***
> ***Century Management***

It appears we are headed into the latter stages of a bull market which started in October of 2002. One of the typical signs of a late stock-market cycle is the emergence of a two-tiered market. In a "two-tiered market" the stock index's rise is based on a small number of advancing stocks. The small number of stocks that typically advance in a two-tiered market are often the large mega-cap "blue chip" Dow stocks.

As the recent shift out of resource based stocks (gold/oil mines) gains traction in 2006, watch for the momentum crowd to provide the fuel for a continued powerful blue chip surge into 2007. Just as most investors did not feel comfortable owning oil stocks when the price was $10 - $15 a barrel (preferring to wait for $40 - $60 oil), likewise most investors have avoided purchasing U.S. stocks with the canadian dollar at $0.90. Instead, we estimate that most will prefer to wait until the dollar drops to the $0.70 – $0.75 range. That's human nature at work!

The recent implosion of Amaranth Advisors, a multi-strategy multi-billion dollar hedge fund, was front page headlines in the financial news. What's our take on this debacle?

We have nothing against hedge funds as part of a diversified portfolio purchased by knowledgeable and sophisticated investors. Nonetheless, buyers should beware of funds which allow; aggressive leverage, excessive concentration of individual positions (e.g., betting 56% of your capital on natural gas prices), or straying from the manager's original investment style expertise. As one expert noted from the Amaranth affair, "outsized returns should spark investment curiosity."

With the decline in long term interest rates over the past 3 months, interest in the Income Trust market has started to pick-up again. Telus's recent decision to convert to an income trust is the latest and biggest example of tax leakage from federal and provincial coffers. Our BCE shares have gained over 15% in the past month on the hopes of its own trust conversion.

Nonetheless, the Trust sector (specifically business trusts), will eventually come back to haunt investors with significant pain. In fact, don't say you have not been amply forewarned by Canada's Conservative Finance Minister. Someone will eventually be paying higher taxes when the smoke clears.

According to the Minister's remarks made this past September, "we continue to monitor developments in the income trust market, and **I remain concerned**…" We can't say when but, in our opinion, the federal government will eventually act to curb the conversion of income-tax paying corporations into trusts. Otherwise, at the present rate there will be no corporations left to pay taxes! Funny how the brokerage industry has been practically silent on this important issue to the yield-hungry retail trust investor. But then again negative news is not good for trust share prices, or when it comes to selling new Income Trust IPO's. Caveat Emptor!

Third Quarter Performance

Your fund ended the third quarter with an net asset value of $2,491.83 per unit, an increase of $127.40 from the December 31, 2005 asset value of $2,364.43 per unit.

During the quarter oil prices peaked at $78 a barrel. The temporary turmoil in the Middle East gave us the opportunity to sell some of our Talisman Energy holdings. This is the first time we have taken profits on oil stocks in over five years.

This quarter was also kinder to our financial service stocks as they benefited from falling 30 year bond yields. The consensus opinion is that short-term rate hikes in Canada and the US are over. All of which positively impacted our portfolio.

During August we purchased 25,000 shares of Retirement Residence Reit. Although being in a so called "hot" sector, real estate and retirement homes, this REIT* was trading well under its $10 IPO price ($7.10 our average cost).

The Reit (which was having operational difficulties) put itself up for sale nine months prior, yet there were no takers. The stars were aligned for the Value Contrarian Fund on this investment as the Canada Pension Plan announced a takeover offer of $8.35 on October 12. While we wait for the deal to close, the regular distribution equates to a yield of 5.9% on our original cost.

On the Canadian side, we also purchased the SFK Pulp 7% convertible debenture. SFK Pulp is a busted forest products income trust which came public a few years ago at $10 and is now trading at $4.38. This is a play on the recovery of pulp prices in Eastern Canada.

The debentures were issued to fund the acquisition of two recycled bleached Kraft Pulp Mills in the U.S. The newly acquired mills provide SFK with both product and plant diversification.

Finally, we purchased some excellent American businesses. Realogy is the largest Century 21 franchisor that was spun off from Cendant. The value in Home Depot was also compelling at under 12X earnings. These are two (out of favour) businesses which throw off lots of free cash flow, buy back significant amounts of their stock and will benefit from the long term growth in real-estate/construction/renovation activity.

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* REIT = Real-Estate Investment Trust

Outlook

Index investors should be on high alert these days; Canada's bench mark index is out of whack… It's the observation that market indexes can lose the benefits of diversification when they become dominated by a couple of hot sectors or supercharged stocks – and with the boom in commodities, the S&P/TSX index is not a diversified index right now.

David Berman
Financial Post Columnist

Late 1999 and early 2000 marked the end of the renaissance era for large-cap growth stocks. Most of them either have gone down or drifted sideways since…(i.e.: Walmart, Microsoft, Home Depot, GE, ect…) But time is the greatest healer, especially when earnings are growing. These companies have more than double their earnings since the late 1990's. Those higher earnings have combined with lackluster stock performance to create very attractive valuations.

Vitaliy Katsenelson
Investment Management Associates

The July/August Middle East tussle has ended, oil prices have dropped over $15 dollar, and long bond yields are back to 4%, after having climbed to 4.6% this past spring. The housing "bubble" is more of an issue related to a few specific higher growth regions that became overheated with speculative excesses. In our opinion, housing will not derail the economy.

For the time being, stock markets have the wind to their back (assuming one ignores the overheated commodity sector).It's clear sailing for now, unless long bond yields undergo a dramatic rise or a surprise financial crisis erupts. Enjoy the fall colours while they last!

Respectfully yours **

Benjamin D. Horwood
Portfolio Manager
October 10, 2006

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.