VALUE CONTRARIAN ASSET MANAGEMENT

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2008 Third Quarter
Value Contrarian Canadian Equity

Dear Investors,

> ***"Five years from now, 10 years from now, we'll look back at this period and we'll say you could have made some extraordinary buys… The American economy over a period of time will do very well and people that own a piece of it will do very well."***
>
> ***Warren Buffett***
> ***CNBC Interview***
> ***September 24, 2008***

> ***No crisis comes completely out of the blue; there are always clues and advance warnings if you can only interpret them correctly. It was the hiccup in the structured credit market [derivatives: collateralized debt obligations - CDO] in May 2005 which gave the strongest indication of what was to come… American carmaker's bonds were widely held in structured-credit portfolios, downgrades [by the credit rating agencies] caused a big dislocation [drop] in the [CDO] market.***
>
> ***Bank Risk Manager (Anonymous)***
> ***Economist Magazine***
> ***August 9, 2008***

What we have been experiencing over the past year has not only been a credit (liquidity) crisis but rather a **crisis of "insolvency**" (impaired, distressed or bad assets). Today we are not witnessing the Great Depression but rather the "Great Recession" of 2008-09 (similar to 1973-74 bear market / recession).

The credit crisis has its roots in a world awash in cash. We would argue that the real root of the crisis is based on human greed and a basic lack of morals/ethics. Mortgage brokers/banks and Wall Street firms were the "enablers" by enticing sub-prime home buyers with "too good to be true" terms & conditions. In the aftermath of the tech bubble and 9/11, Alan Greenspan cut

short-term interest rates to historical lows in order to kick-start spending and prevent a recession.
Greenspan's gambit worked, if anything too well, while triggering an explosion in global liquidity. The result was a remarkably benign economic environment where volatility in financial markets practically disappeared.

The strong stable economy of 2003-2007 began to lure investors into a false sense of security. Investors began to behave as if the chance of losing money had all but disappeared. Or that unlimited demand from China and India would cure any possibility that commodities could actually suffer a precipitous price decline.

This indifference to risk has had severe consequences. Remember, when the sky is perfectly blue, when there is no wind or clouds, and the flowers are in perfect bloom, this is actually one of the most dangerous times to invest. Likewise, when the recent front cover of the Economist magazine features an investor peering over the edge of a cliff into the abyss, this often is an excellent contrary indicator (i.e. time to invest).

So what major lessons have we learned from the credit crisis mess?

1. Illiquid / Complex / Opaque/ Hard To Value Investments = Danger !!!

   Securities which exhibit the above characteristics are a recipe for disaster. One has to look no further than the Asset-Backed Commercial Paper (ABCP) debacle in Canada, or Auction Rate Securities (ARS) in the U.S.A. Moreover, if an investment has to be valued using a complicated computer driven modeling system, perhaps it's best to take a pass.

2. Systemic Risk & Sowing Seeds of Doubt – Lehman Brothers Bankruptcy

   From a historical perspective, the bankruptcy of Lehman Brothers will be seem as one of the pivotal (tipping) points during the credit crisis. The Lehman bankruptcy in mid-September marked the almost complete break down of trust between lenders and borrowers. It had a "domino effect" on the world financial system (which bank would fail

next?) and paralyzed the short-term funding markets in America. If Lehman's commercial paper was toxic then perhaps all other corporate paper was potentially suspect. Investors began "en masse" to seriously question the asset quality in their "safe" money market funds. Institutional investors were unwilling to risk lending unsecured funds to banks or even buy commercial paper beyond one day issues by highly rated companies. The "domino" theory was in full play regarding the U.S. banking system. The Lehman bankruptcy demonstrates how systemic risk can lead to the freezing up of the entire credit markets.

3. Don't Be Fooled By Triple "AAA" Ratings

For all we know Moody's and S & P (the rating agencies) could turn elephant dung into a triple "AAA" investment if it was sliced and diced in the "correct" fashion. Bottom line, if an investor wants to gauge a company's financial "health check", (based on free market forces, not prepaid rating agencies), they must inquire into the price of Credit Default Swaps (CDS).

CDS's are a form of insurance one can buy as a hedge against a bond default. The buyer of a CDS contract essentially pays annual premiums and the seller agrees to pay back the bond principal if the issuer of the bond doesn't. It's different from home or auto insurance in that an investor (the buyer of a CDS contract) doesn't actually have to own the underlying bonds – he can simply buy a CDS as a way to make a bearish bet on a company or to offset other risks.

For example, in the fall of 2007 it cost $35,000 dollars to insure against the default on $10 million of G.E. Capital bonds. By the end of October 2008 this same coverage cost $584,000 dollars. The recent liquidity crisis in commercial paper has obviously created financial stresses on G.E. Capital. Yet the rating agencies still assign GE Capital their coveted triple "AAA" rating.

When it costs $1,000,000 dollars to insure $10 million dollars of bonds, that's one indicator pointing to severe financial distress or potential bankruptcy. Credit default swaps provide investors with an early warning of financial troubles ahead. They also

paint a clearer (not perfect) picture regarding the present financial situation of a given company. Moreover, there is not the same inherent conflict of interests that exist with the rating agencies. Uncle Ben says: "Don't leave home without credit default swap pricing information". CDS contracts are the way that investors now price credit. According to one respected short-seller: "if the rating agencies will downgrade only when we can all see the losses, then why do we need the rating agencies?"

4. Watch Out for "Bubbles" – Particularly Those Based on Financial Leverage

Bubbles based on leveraged real-estate (residential or commercial), are much more dangerous to the economy and financial system than the bursting of an equity bubble based on overvalued stocks (i.e. technology, oil , bio-technology). Wall Street's ingenuity led to the re-packaging of sub-prime real-estate mortgages into derivatives. These "toxic" derivative securities (think ABC Paper) were subsequently resold around the world to various financial players. Between 2002-2007 Wall Street investment banks were the equivalent of a swarm of honey bees producing the "mother of all" (derivative) pollination parties. The party ended when investors caught wind that the assets within these complex, leveraged, illiquid, derivative vehicles were full of impaired sub-prime mortgages.

5. The Repricing of Credit Risk –Truth and Consequences

Over the past few years fixed-income investors prostituted themselves by accepting yields that were not commensurate with the risks. As a result, credit spreads between risk free U.S. Government Treasury Bonds versus (riskier) corporate / junk bonds narrowed to historical lows. As riskier LBO takeover deals became more expensive, investors should have demanded far higher rates to finance them. But incredibly, from 2003-2007 as short-term interest rates rose, long-term rates fell, effectively making money cheaper to borrow. (Normally, when short rates go up – long rates also move up).

The credit spread between junk bond debt and ten-year (risk free) U.S. Treasury Bills (in effect the price the market puts on risk) contracted from 10.0 percentage points (the

recession of 2002) to a mere 2.6 points by July 2007. In plain language, by last summer risky junk bonds yielded a mere 2.6 points above risk free U.S. government debt. This cheap money just added fuel to the LBO and sub-prime craze. Investors (creditors) were clearly not being paid for the risks they were taking on. Going forward, expect fixed-income investors to demand much higher risk premiums (even if inflation remains subdued).

6. Momentum Investing Can be Especially Hazardous to Your Financial Health

A key element to successful investing is the fact that patience, discipline, and conviction trumps "momentum". Investing requires a "bulldog" character. That means the ability to say to clients: no, no, and NO!!! No to inflated oil stocks, no to high tech-telecom and a double no to Nortel!! As these particular sectors (stock) soared on the back of speculative excesses, staying on the sidelines certainly looked temporarily wrong (unless of course one was early to the party when valuations were reasonable).
Example:

Petro Canada	October 10, 2008 price – $23.70 (May 2003 same price)
Encana	October 10, 2008 price – $43.50 (June 2005 same price)

Simply stated, investors who were caught up in the India/China story may have purchased a round-trip ticket on their oil stocks. With respect to the above stock prices, the last time Petro-Canada touched $23.70 was in May 2003. The last time Encana touched $43.50 was in June 2005. When oil was out of favour and trading in the $12-$16 range (late 1998) investors could have purchased Petro Canada shares for a mere $8.00. By 2005 investors were not investing, but rather engaging in speculation on the price of oil.

7. Don't Confuse Bank Depositors with Common or Preferred Bank Shareholders

Despite the systemic risk to the global financial and banking system, we cannot think of an instance whereby European or North American retail bank depositors lost money. Nonetheless, don't confuse a bank bailout as a bailout of common/preferred shareholders. During the credit crisis the latter shareholders lost all or nearly all their

capital (i.e. Washington Mutual, Indy Mac, Fannie Mae and Northern Rock in England). The statement: “don’t worry the government will bail us out” applies to depositors not common shareholders.

8. Ticking Time Bombs – Corporations that Rely on Short -Term Commercial Paper and Asset Securitization Markets

The credit crisis has exposed the raw dangers non-bank financial corporations (i.e., G.E. AMEX, CIT) face when they rely on short-term commercial paper borrowing to finance long-term assets. This form of financing can be a ticking time bomb as it relies so heavily on “trust & confidence”. All it takes is one major player in the short-term commercial paper market to break this trust (i.e., default) and the “dominos” start to quickly tumble!

With the failure of Lehman Brothers (and its corporate paper), the final straw of trust was broken in the American financial system. One of the consequences was that demand for corporate commercial paper and asset securitization literally dried up. The seized- up securitization market has impeded the ability of non-bank finance companies to sell-off (securitize) car, education and auto loans. Financial companies which did not possess a stable branch banking depositor base were at the mercy of borrowing short-term money in the commercial paper market. Borrowing short-term money to finance long-term assets relies on trust, confidence, and a healthy financial system. When the system suffered a “heart attack”, the U.S government had to step in and back-stop the corporate commercial paper market. Companies which rely heavily on borrowing in the short term credit markets now have to reduce their leverage and think about creating a more conservative business model.

9. Go Big - Go Smart – It’s Your Insurance Policy

In our opinion, this crisis has highlighted the importance of dealing with large Canadian banking institutions. The fees and charges may be higher, but one has to look at it as a type of insurance policy on your account. Three recent examples come to mind: 1) The Portus investment fraud; 2) The ABC commercial paper debacle, and; 3) The Auction

Rate Securities (ARS) mess (where certain Canadian banks misled U.S. investors about the safety of these securities). Big institutions not only have the desire to avoid reputational risk but also the financial means to make clients whole in order to preserve their reputations. In recent instances smaller Canadian financial institutions did not have the leeway to compensate their customers like the big boys. But don't take this to mean the large players are "Saints" – they're not! It's always best to follow the "caveat emptor" rule.

10. The China & India Myth

The present bear market has certainly shredded the myth that insatiable demand from booming China & India practically guarantees high commodity prices for the foreseeable future. We always viewed this notion with a skeptical eye.

Also investors seem to forget that growth with meagre profits, or investing in overvalued assets is not a recipe for great long-term investment performance. Your ultimate returns will always depend on how well (cheaply) you initially buy.

11. Where's Waldo? Where's the Safe Dividend?

It appears from past history (think 1973-1974) that severe bear markets/recessions go hand in hand with extreme energy price increases (i.e., July 2008). During this recession, financial companies have been at greater risk regarding potential dividend cuts for three basic reasons.

Banks are a proxy for the economy and thus affected by severe recessions. Unless management is a "cut above", these companies' loan portfolios and investments are potentially subject to the speculative excesses of the recent past. Secondly, banks are leveraged institutions. Leverage may work against shareholders when the economy turns south. Finally, banks on paper appear to have large earnings capacity. Nonetheless, 30%-40% of this earnings power is often already spoken for through the existing dividend payout. Should a bank incur large losses a dividend cut may be required to rebuild its capital ratios.

Bottom line, leverage and dumb management, whether at a financial institution or an industrial company is a potential lethal brew to a safe and secure dividend payout.

12. Listen To The "Smart Money" – Not Coffee Room Chatter.

On October 17, 2008 Warren Buffett (in the OP-ED of the NY Times) wrote:

> So…I've been buying American stocks. This is my personal account I'm talking about, in which I previously owned nothing but United States Government bonds……. Today people who hold cash equivalents feel comfortable. They shouldn't. They have opted for a terrible long-term asset, one that pays virtually nothing and is certain to depreciate in value. Indeed, the policies that government will follow… will probably prove inflationary and therefore accelerate declines in the real value of cash accounts …..
> Equities will almost certainly outperform cash over the next decade, probably by a substantial degree. Those investors who cling now to cash are betting they can efficiently time their move away from it later. In waiting for the comfort of good news, they are ignoring Wayne Greteky's advice: "I skate to where the puck is going to be, not to where it has been."

Third Quarter Performance

Your fund ended the second quarter with an net asset value of $2,162.50 per unit, a decrease of $289.24 from the December 31, 2007 net asset value of $2,451.74 per unit (after distribution).

We realize that the past year has been most unsettling for investors. We understand that market volatility is scary to most. Unfortunately, this will likely be a year of negative returns for the fund. This situation has only occurred once before in our history. I apologize for the poor performance and have learned significant lessons from today's secular bear market decline (see previous pages). As you know, I am a significant owner myself so I understand and appreciate your concerns.

We are "Value" investors, not "Momentum" investors. Yes, we have been taking advantage of the spectacular decline in stock prices over the past few months. October and November have been especially fruitful. In these types of markets we have been able to buy dollar bills for .60¢ cents or less. The severity of the pain felt by others in the stock market is what is creating desperate sellers – and thus, mouth watering investment opportunities for your fund.

The present bear market has also allowed us to revisit long lost friends. These are favourite stocks which we previously owned or were too expensive to purchase more of. We have uncovered great buys in both large blue chip U.S. growth stocks all the way down to Quebec micro-cap stocks. We have also been able to buy companies selling for under their net working capital. In these circumstances (classic Ben Graham value) we receive all the fixed assets and real-estate for free.

As at the end of September, our year-to-date redemptions have been about 4% of average combined net assets. Redemptions have been very manageable and I thank you for your confidence and support. For the record, I purchased additional units on October 1, 2008. A large percentage of my personal wealth continues to be invested in the Value Contrarian Fund. I am very optimistic regarding the present portfolio, especially our long-term exposure to China. We are well positioned for the future and appreciate your patience.

Outlook

> ***In truth, bear markets often end not in a crescendo of selling but a cloud of indifference… You're more likely to see a unicorn in your backyard… than you are to spot an indisputable sign of market capitulation.***
>
> ***Jason Zweig***
> ***Wall Street Journal***
> ***October 15, 2008***

> ***Theoretically any increase in the monetary base must be met with a tightening [higher interest rates] if inflation is to be avoided. Right now, the Fed is pursuing a pro-inflation strategy… They're not even considering inflation. Paul Volker learned that success in fighting inflation comes from tightening monetary policy.***
>
> ***Anna Schwartz***
> ***Professor Emeritus***
> ***N.Y. City University***

The U.S. government needs to sell hundreds of billions of dollars in new bonds to finance its comprehensive plan to quell the credit crisis. Perhaps there are one or two more rate cuts in the pipeline. In our view, within 6-12 months of the last rate, cut the Fed will avoid Greenspan's June 2005, "conundrum" dilemma by quickly and aggressively raising short-term rates.

In coming years, (unlike the 2003-2007 "conundrum" period) bond investors will force long-term interest rates to rise more than expected. Creditors will now demand higher yields on long term bonds after experiencing the folly of accepting inadequate risk premiums over the past five years. Remember, the government sets short term interest rates. However, long term (10-30 year) bond yields are set by free market forces.

During the next few weeks we do not expect the stock markets to exhibit "irrational exuberance". Our best "guess" (yes, guess) is for the markets to have bottomed by year-end 2008. We don't expect a "V" recovery but more likely a "W" shape recovery. October 10, 2008 seems to have been the bear market's intraday point of maximum pessimism.

With widening and concerted global efforts underway, the wholesale systemic failure of the global financial system is now off the table. Each day is one day further along the road to recovery. It will be a painful process due to the enormous degree of past speculative excesses that requires massive deleveraging.

Expect more surprises. If one of the major auto companies were to go under we would surmise Chrysler as being the likely candidate. Being privately owned, Chrysler's hedge fund bosses are less sentimental, while being ruthlessly practical.

We feel that the 40%-45% stock market decline over the past year discounts (to a large degree) the severity of the present recession. Remember, the stock market is a discounting machine and will start to rise well before the end of the recession. The next few months will form part of this bottoming process.

Present market volatility is our friend as it brings us better prices from irrational investors. For the foreseeable, future investors will gravitate towards the biggest and strongest dividend paying "blue chip" stocks. Nonetheless we see some great small caps bargains (especially in Quebec).

The business of Value Contrarian Asset Management is all about two key elements: "**confidence** and **trust**". It is something we have to earn from our investors each and every day. The present credit crisis has made us appreciate these factors all the more. In today's financial environment it is not only about reality, but also about perception. We "get it".

We are proud to announce that the accounting firm of **Deloitte &Touche** has been engaged as the Value Contrarian Fund auditors for the year-ending December 31, 2008. In addition, we have also instructed Deloitte to perform a mid-year spot check in order to keep us on our toes.

We chose Deloitte through a reference from the Formula Growth Fund (a well known Montreal fund in operation since the 1960's). Deloitte's Montreal office has a practice that specializes in the financial service sector. We look forward to working with Delli Colli and Haig Vanlian. They are both highly qualified professionals in our area of operation.

Respectfully yours **

Benjamin D. Horwood
Portfolio Manager
November 18, 2008

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.