VALUE CONTRARIAN ASSET MANAGEMENT

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2006 Second Quarter
Value Contrarian Canadian Equity

Dear Investors,

> ***Warren Buffett very recently made a $4 billion acquisition, in Israel, of all places. He thinks one of the most bombarded regions in the world is now a good place to invest in. But it should also tell you that if you find a deep value, do not let present war conditions deter you. Wars come and wars go, but markets always remain.***
>
> ***Avner Mandelman***
> ***Giraffe Capital***

> ***The only good deal (in Lebanon) will come if Iran and Hezbollah become convinced they have more to lose than to gain from their ambition of wiping Israel from the map .***
>
> ***Henry Kissinger***
> ***Former U.S. Secretary of State***

There is a saying among the Taliban: "They have the watches. We have the time." The Mid-East is presently in turmoil, and whether we like it or not, it will affect us in Canada.

In Afghanistan a significant portion of the local population is not united behind the central government. According to one Afghan parliamentarian, "it's not that the Taliban is strong. It is that our government is weak (corrupt)." Outsiders (i.e., NATO) are not viewed as liberators. Moreover, as Afghanistan is not an immediate (katusha rocket) threat to Canada, <u>our conviction and motivation</u> to a long and drawn-out bloody fight is limited. The enemy knows this all too well.

Afghanistan poses a major dilemma for the Canadian government. Simply stated, it's extremely tough to win a protracted guerilla war on foreign soil. On the other hand, if Canada does nothing, "what happens when those far off places come back to bite you?" Our heart felt sympathies go out to the families of Canadian soldiers who have been injured or lost their lives in this difficult on-going conflict.

Conflict in the Middle East invariably translates into turmoil with respect to energy (oil) markets. It has always been our belief that oil supply disruptions are one of the key future threats to continued economic growth and prosperity in the world economies. If oil is at $75 a barrel without a major supply disruption, the prognosis is not bright should a disruption occur.

As an aside, here is an interesting fact concerning the country of Lebanon which most commentators rarely mention. The Shiites (represented by Hezbollah) comprise 40% - 50% of the total Lebanese population. Yet they only hold 35 of 128 seats in Lebanon's parliament. While Lebanon's political system assigns the non executive post of parliament speaker to a Shiite, it bans Shiites from becoming president (Christian post) or prime minister (Sunni post). Seems like a recipe for continuing malcontent among a major portion of the Lebanese population. How much of the present day divisions within Lebanon have their origins from this political fact? The nightly news rarely delves into the complicated issues that lurk within Lebanon's deeply divided sectarian society.

Finally, some of the most attractive valuations in the stock market today are to be found in the big cap blue chip growth names of the Dow Jones Index. Simply stated, these stocks are all significantly down in price from their late 1990 highs. As one financial writer aptly stated, "the cold reality of miserable stock performance leaves no room for argument: these stocks (in the late 1990's) were grossly overvalued".

In 1999 Microsoft ($60) had a P/E ratio in excess of 50 and earned $0.70. Today the stock ($24.00) has a P/E ratio of 17 (or 15 if one strips out $3.00 of cash per share) and will earn $1.40. Home Depot is another good example. In 1999 ($69) the company had $1.00 of earnings and a P/E ratio of over 45. Today the stock ($34.00) trades at under 12X earnings and will earn $3.00 a share.

These stocks have disappointed because they were overpriced in the late 1990's and it has taken over half a decade for the valuations (P/E's) to catch up with their fundamentals. However, in times of uncertainty their defensive qualities make them less risky stocks. It's not a question of if but only of when these blue chips growth companies will start to provide superior stock market performance.

Second Quarter Performance

Your fund ended the second quarter with a net asset value of $ 2,351.21 per unit, a decrease of $ 13.22 from the December 31, 2005 asset value of $ 2,364.43 per unit.

Rising long-term interest rates contributed to a strong headwind during the second quarter. From 4.02% at the end of 2005, the yield on 30 year government of Canada bonds rose to 4.6%. As a result, the interest sensitive components of the Value Contrarian portfolio (banks/ financials) were negatively affected. However, this situation created positive buying opportunities for your fund – especially in the income trust sector.

What a difference 6 months makes. Last year investors gorged themselves sick on income trusts, as demand exceeded supply and pricing clearly favored the sellers. Fast forward to the second quarter of 2006 and it was now a buyers market. Sellers (of income trusts) now wishing to go public had to provide increased yields, while reducing the pay-out ratio to below 100% (thus creating a more conservative trust). It was in this environment that we purchased a number of income trusts through their initial public offering (IPO).

AutoCanada Income Fund ($12.85) is now a top 5 holding in the V/C fund and was purchased at $10.00, with an initial yield of 10%. The company is one of Canada's largest multi-location automobile dealership groups, with 14 franchised automobile dealerships in six provinces. In 2005, AutoCanda sold approximately 19,000 vehicles and processed approximately 204,000 service repair orders.

AutoCanada currently sells new vehicles manufactured by DaimlerChrysler, Hyundai and Subaru. A Ford dealership was recently purchased and the company will be opening further foreign dealerships this fall.

The company intends to continue its growth strategy by acquiring additional franchise dealerships. Interestingly, when a car manufacturer grants a dealership to AutoCanada there is no cost to purchase the franchise business, just the cost of setting up the physical dealership.

AutoCanada has all the elements of a strong income trust model (see attached Gazette article). The income trust structure also provides AutoCanada with an attractive acquisition currency in the pursuit of its consolidation strategy.

During the quarter we revisited a stock from the past and added BCE ($26.40) to the portfolio. We view BCE as a temporary place to park cash based on its safe dividend yield (5%), a net asset value of approximately $35, management initiatives to surface value (i.e., Bell Aliant spinoff), and the prospect of an end to the rising interest rate cycle.

The problem over the next 3-5 years is that BCE is likely to lose approximately 30% of its local (high margin) telephone line business to the cable companies. However, for every local telephone customer BCE loses, it is gaining a similar number of internet, wireless and satellite customers. Unfortunately, the latter businesses are not nearly as profitable as the local telephone line business. Thus BCE will not be one of our long term buy and hold investments.

Outlook

> ***The conventional wisdom on Wall Street holds that as soon as the Fed quits tightening, the market is going to take off again. It did that in 1994-95 and in 1989…. But in almost all other cases, the market went down after the Fed quits tightening because either we were headed into an earnings slowdown or we had some crisis…***
> ***It is not wise to bet against the Fed.***
>
> ***Ned Davis***
> ***Ned Davis Research***

The present conflict between Israel and Hezbollah always has the possibility of escalating into a wider regional conflict. The "wildcard" is the threat of an oil supply disruption.

According to BCA Research in Montreal, "while the global economy has shown impressive resilience to rising energy prices in the past three years, the adverse impact will become pronounced as the earlier tailwind from low interest rates and booming housing fades… Bottom line: high oil prices will dampen global economic growth."

We would not be surprised to see an increasing number of corporate profit warnings in the second half of the year. In addition, the Federal Reserve has recently admitted that the threat of "inflationary pressures" remains. Wiggle room thus exists for a further U.S. interest rate hike this fall (if deemed necessary).

Expect continued volatility in the financial markets, which may create further equity opportunities for your fund manager. Remember, we view stock volatility as our friend. Should oil prices drop $15 – $20 dollars (the contrarian view), stock markets could surprise investors with significant upside potential. We remain cautiously optimistic for the remainder of the year.

Yours very sincerely **

Benjamin D. Horwood
Portfolio Manager
14 August 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.