2004 Second Quarter
Value Contrarian Canadian Equity

Dear Investors,

> ***You're paying us to decide when to hold onto <u>cash</u> and when to invest it…We've always believed successful investing involves recognizing and correctly choosing among a series of trade-offs. <u>Cash</u>…is a way of <u>safely doing nothing until compelling investment opportunities arise.</u>***
>
> ***Seth Klarman***
> ***Baupost Group***

> ***The threat to the political and economic world posed by Saudi instability, I think is greater than the threat that was posed by Iraq… US policy makers should worry about being caught by surprise events as they were in 1979 with the fall of the Shah in Iran…(No one really knows) how many termites are undermining the house of Saud.***
>
> ***Richard Clarke***
> ***Former White House***
> ***Terrorism Expert***

The run-up in oil prices during these past few months has caused concern in many quarters, including the financial markets. Simply stated, higher oil prices act as a tax on all consumers, thereby damping the global economic recovery. A further risk is that expensive fuel raises company's costs (squeezing profit margins), which in certain cases affects corporate profitability (think for example: airlines, transportation companies, and chemical manufacturers). Moreover, energy price increases, if substantial, could lead to further inflation. This might force the Feds to initiate significant interest rate hikes in order to choke-off economic growth.

Based on past history, the rise in oil prices is potentially troubling, because most of the major downturns in the industrialized world since the 1970s have been foreshadowed by crude-oil shocks.

With the world oil production and distribution systems so stretched: ". . . any surprises get magnified by oil markets" according to Larry Goldstein, the President of Petroleum Industry Research Foundation. The International Energy Agency (IEA) recently estimated that OPEC had only 620,000 barrels a day of idle pumping capacity in a global system supplying about 80 million barrels of oil a day.

Finally, oil prices today also reflect a "terror premium" based on fears of terrorist attacks that might disrupt Middle-Eastern oil exports. The unpleasant truth is that the world depends for a plentiful supply of oil on an "opaque", "nasty regime" called Saudi Arabia. Saudi Arabia matters because it is the world's largest exporter of oil and also happens to be the only country with supposedly significant idle capacity. It is also a country where terrorism is now clearly a serious problem.

What happens if Saudi output is severely disrupted due to internal strife/terrorism? Barring a slowdown in the Chinese and/or the Western economies, world oil markets would be severely disrupted by the loss of Saudi oil. There is less spare capacity today than at almost anytime in the past 35 years, so prices could skyrocket if demand stays high and capacity is lost to terrorism or civil strike: likewise if Nigerian and Russian export production was cut for some reason.

In our opinion, oil and oil issues will be a dominant theme affecting the financial markets over the next 10 years. Going forward, our investment decisions and analysis will include the distinct possibility of another oil shock/crisis in the medium term. While we certainly can't predict the future (or oil prices for that matter), we are risk adverse investors and concentrate more on controlling our downside risk than shooting for the stars!

In our universe "cash" is not a four letter word, but a legitimate investment option we will continue to utilize. Or, as one astute manager recently commented, "if keeping up with an overvalued and rising market is your goal, cash is an unacceptable anchor to drag around." Obviously we don't view cash as an "anchor". A better term would be "life-preserver".

Second Quarter Performance

Your fund ended the second quarter with a net asset value of $2,024.46 per unit, an increase of $93.47 from the December 31, 2003 asset value of $1,930.99 per unit.

We don't spend our time trying to make forecasts because, simply stated, they are usually wrong. Where the price of aluminum, 2 by 4's or interest rates will be headed in six months or a year from now is not something we can predict with any degree of accuracy. However, we do have a good idea when a stock represents great value.

The general consensus was that interest rates would not be going up during the first half of 2004. Yet low and behold, that is exactly what they did at the end of June. Long-bond yields actually started to rise in early March. This factor (along with rising oil prices) put stiff pressure on stock prices during the quarter.

The biggest problem these days is that it is difficult to uncover low P/E stocks. From the panicked lows of October 2002, stock markets have had a sustained move, thus eliminating most of the low hanging "bargain" fruit.

During the quarter we sold our remaining position in Yellow Pages, home renovation stock Rona Hardware, and reduced our holdings in Magellan Aerospace. We made descent profits on these investments but felt it was prudent to reduce our exposure to the cyclical construction sector (Rona), and oil sensitive aerospace industry (Magellan).

During the second quarter, bad news or one-off events gave us the opportunity to add to a number of our existing holdings. We added to our Molson's position when they missed their earnings numbers as a result of their problematic Brazilian operations. In the medium term, Molsons is also a potential takeover target as a result of the consolidating global beer market, and internal ownership conflicts at the company.

We also benefited from the sell-off in the shares of blue-chip Swiss drug-maker Novartis. The shares dropped on worries that the company might start a bidding war for the Franco-German drug-maker Aventis. And finally, we were able to add to our position in Microsoft as a result of a negative European commission ruling which caused the shares to weaken.

Other than a small opening position in the Atlas Cold Storage Income Fund, our single major purchase during the quarter was in shares of the busted tech company BCE Emergis.

The investment idea in BCE Emergis came to my attention thanks to Lee Matheson. For those of you who attended our annual V/C Fund Luncheon in January, you will remember Lee for his keen investment analysis. Lee is also our Fund's substitute Manager. In case that famous "runaway bus" somehow manages to meet up with me one (slippery) day, Lee will be there in the crunch.

BCE Emergis is a stock which definitely can be qualified as a “fallen angel”, having dropped from $189 dollars in 2000 to its present level of $3.85. Our average cost was $3.95, taking into account the recent $1.45 special dividend. The opportunity to buy in arose when parent company BCE decided to dump its entire ownership position. The market didn’t like the fact that BCE would no longer be affiliated with Emergis and the stock fell.

At the time of our purchase the company had minimal debt and approximately $4.00 a share in cash. Thus we were purchasing a company for almost the cash in the business.

The company operates in two main sectors: 1) E Health – Emergis operates the largest private electronic real-time point-of-sale claims network for adjudicating prescription drug claims and transmitting dental claims in Canada. 2) E Finance – Emergis’ electronic bill payment and tax filing division. This business allows companies to process mortgages, invoices, and payments electronically.

After the payment of a $1.45 special dividend, the company will be left with approximately $270 million dollars or $2.62 per share in cash. Although the company’s balance sheet is rock solid, this investment is <u>more speculative in nature</u>. The key to the future of BCE Emergis is how well present management can allocate the excess cash and <u>profitably grow</u> the business.

On an interesting note, Jean Morty (of BCE fame) recently joined the Emergis board and purchased 2 million shares with his own money. Remember, Monty was the “hero” for selling Bell’s Nortel position at $90, but was also a “zero” for spending billions to buy Teleglobe at the height of the telecom bubble. Let’s cross our fingers that the right (full) Monty has shown up for this deal!

2004 Outlook

> ***The exhilaration we experienced the previous few years buying bargains from panicked sellers has now yielded to less rewarding…opportunities, across considerably less fertile terrain. There is not nearly as much financial distress or investor pessimism as in the past several years. There are few urgent sellers.***
>
> ***Seth Klarman***
> ***Baupost Group***

June 30 was the kick-off of the U.S. interest rate tightening cycle, the first in four years. Over the past few years the Fed slashed rates to a 45 year low of 1 per cent in response to the bursting of the stock market bubble, the 9/11 attack, and recent deflationary fears.

The impact of higher short term rates on the financial markets and the economy will likely be initially muted, because short rates are starting from such a low level. As one money-manager bluntly stated: "Who cares if Alan Greenspan raises short-term rates by a quarter or half a percentage point? A yield of 1.5% to 1.75% …is still a sign that the punch bowl is open for drinking." Nonetheless, higher rates will depress price/earnings ratios, thus taking the wind out of continued good earnings news.

In contrast to the 1994-1995 interest rate cycle, the U.S. Central Bank has devoted considerable effort to preparing the ground for higher rates, thus providing financial institutions and the bond markets time to adjust to the increase in short-term financial costs.

One of the risks to Mr. Greenspan's "gradualist" approach, is if the Federal Reserve under-estimates inflation and is forced to raise rates more sharply than expected, thus dampening consumer spending and business confidence.

Barring an interest rate shock or an unexpected geo-political/oil crisis, we see the stock markets muddling through the remainder of the year on a positive note. Any oil price correction would likely spur equities. However, Saudi Arabia, Iraq and Nigeria remain the oil wildcards.

Respectfully Yours,**

Benjamin D. Horwood
Portfolio Manager
July 15, 2004

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. **Pity.**