



Focused Opportunities Fund Mid-Year Update -- 2010

July 5, 2010

Dear Investors:

During the first 6 months of 2010, the TSX Composite declined 3.85% while the S&P 500 lost 7.57%. Through this same period the Focused Opportunities Fund gained 1.32%. Since its inception over 5 years ago, the Focused Opportunities Fund has generated a compound annual return of 9.15% (with 7.46% volatility) relative to a 3.24% compound annual return for the TSX Composite (with 16.97% volatility). The Fund has also protected capital well in difficult markets with a maximum drawdown of 14.02% compared to 44.80% for the TSX Composite.

Fund Attribution & Positioning

Through the first half of the year, the Fund generated 1.1% from long positions and 0.2% from short positions. Positive performance was driven by Canadian equity positions (both longs and shorts) and by U.S. short positions, while losses on U.S. long positions partially offset these gains. Positive attribution was a result of gains in the consumer cyclical sector (1.4%), the industrial sector (0.4%), and the communications sector (0.3%). The technology sector (-0.6%) and the consumer non-cyclical sector (-0.5%) were a drag on returns.

The Fund became increasingly defensive during the first two quarters of the year and now sits with a gross exposure of 85% and a net long exposure of +28%. Due to the conservative nature of many long positions and generally higher beta short positions, the beta-adjusted net exposure remains materially lower at only +14%. With mounting evidence of slowing global economic growth, new worries over sovereign debt risks in Europe, and our continuing concerns over long-term structural economic issues, we believe a cautious stance is warranted. With high levels of cash and a low net exposure we are well positioned to navigate potentially challenging equity market conditions over the remainder of the year. Despite this defensive stance, we continue to identify selective security specific opportunities that warrant a modest allocation of capital.

Should equity markets continue to weaken from current levels, we believe we are well positioned to weather the storm and to take advantage of potential market dislocations while adding opportunistically to new investments.

Economic & Market Outlook

We continue to view the recent economic recovery as fragile. U.S. unemployment remains high at 9.5%, consumer spending continues to be anemic, and estimates for global GDP growth have begun to moderate. Importantly, this sub-par economic recovery is all against a backdrop of unprecedented monetary and fiscal stimulus, without which the global economy would certainly be in a far more dire situation. Going forward, central banks and government leaders will face the challenge of withdrawing this stimulus without pushing the global economy back into a recession. As this recovery faces setbacks it also remains unclear what ammunition fiscal and monetary authorities will have to ward off a potential “double-dip” recession that some pundits have cited as a significant risk.

Over the last 6 months, new economic concerns have emerged. In our view, the most significant of these are the ongoing sovereign debt crisis in Europe as well as the developing slowdown in China. Over-levered European government balance sheets are not a new phenomenon, but one that the financial markets have only recently chosen to pay close attention to. During the 2nd quarter, bond markets punished European government debt and credit default swap spreads on many government issues widened dramatically. As a result, the cost for many nations to refinance existing debt will rise significantly going forward. European governments have attempted to present a united front and have announced significant austerity measures to cut deficits and increase confidence in the ongoing viability of the European Union. While these cost reduction decisions are likely necessary, the implementation will be challenging and, if successful, will have a negative impact on economic growth in the region over the mid-term. Furthermore, the European sovereign debt issue highlights the limited borrowing capacity of governments around the world and suggests that similar difficult fiscal decisions in North America can not be far behind. China will clearly be a key driver of global economic growth for many years to come. Unfortunately, the path to prosperity for China will not be without bumps in the road. Recent comments from Chinese authorities regarding an overheated real estate market, restrictions on bank lending, weak leading economic data and the very poor performance of the Shanghai stock market all suggest that China could be a near-term risk to global financial markets.

While equity market valuations are not as expensive as they have been at many points over the last 20 years, they are also not cheap on a longer term historical basis. With many near-term risks to the economic outlook, longer term structural concerns, and weakening technical equity market indicators, we believe caution is warranted with respect to equity market performance for the remainder of 2010.

Strategy

In the near term, we intend to remain defensively positioned. We will maintain a modest net long market exposure and plan to increase our gross exposure as new investment opportunities are identified. Importantly, we plan to maintain ample amounts of cash in order to preserve flexibility within the Fund should equity market conditions continue to deteriorate. Liquidity and the ability to act opportunistically in a challenging market environment will, in our view, be essential elements of a successful investment strategy over the next several quarters. Across our long book, we will continue to emphasize quality, strong free cash flow, balance sheet health and will increasingly look for names with attractive dividend yields. In contrast, the short book will be characterized by those companies with high levels of economic cyclicality, weak balance sheets, vulnerable business models, and premium valuation multiples. We will also continue to focus on larger capitalization equities and minimize our exposure to less liquid small capitalization equities that could be more vulnerable in a weak equity market environment.

New Investment Ideas

We have highlighted below a few of our most recent and highest conviction investment ideas.

The Brick (BRK.UN) is one of Canada's largest furniture, mattress and appliance retailers. The company operates 236 retail stores under a variety of banners and today holds approximately 7.1% market share in the Canadian furniture, mattress, appliance and home electronics markets. During the economic downturn of 2008/2009, the company was negatively impacted by declining sales, restrictive financial covenants and inventory supply issues. As a result, the firm went through a significant restructuring that involved the suspension of unit distributions, a debt refinancing transaction led by Fairfax Financial and other institutional investors, and an overhaul of the management team. As a result of this restructuring, the company now has significant financial flexibility and improved access to inventory. Thus far, the new management team has cut costs, improved gross margins, and worked to improve inventory and supply chain management. The company has reported record results in each of its last 2 quarters and appears to be at an inflection point with respect to comparable store sales. At recent trading levels, The Brick also offers investors exceptional value. The units trade at only 3.3x 2010E EV/EBITDA and offer a 20%+ free cash flow yield. At a more normal 6x EV/EBITDA multiple, The Brick units would trade at \$3.09/unit, or 62% higher than current trading levels. With a restructured balance sheet, improving sales trends, and a compelling valuation, we believe The Brick is an under-followed investment opportunity with significant upside potential.

Another recent addition to the portfolio is Vodafone Group (VOD) – one of the largest mobile communications companies in the world. At current levels, we find Vodafone's valuation quite compelling; one of the primary reasons being that the market is currently placing zero or very

little value on Vodafone's 45% ownership stake in Verizon Wireless – an extremely valuable asset that generates a significant amount of free cash flow. Due to an accounting convention called the *Equity Method*, Vodafone's share of Verizon Wireless' EBITDA and free cash flow goes completely unaccounted for and is essentially "hidden". As a result, this artificially deflates Vodafone's true cash flow generating power and thus the overall value of the firm. Based on our conservative estimates of what the Verizon Wireless stake is worth, we feel that Vodafone's stock should be trading at least 30% higher than where it is today.

We also find Vodafone's current 6% dividend yield to be quite attractive. It is our belief that at some point in the near future, Verizon Wireless will begin to use its free cash flow to pay dividends up to Vodafone – something they were previously unable to do because of debt repayments related to the acquisition of Alltel. Should a dividend be implemented by Verizon Wireless, Vodafone would have the ability to increase its own current dividend by 60-70% which would further enhance our expected return.

Summary

We are confident that our long/short strategy is an ideal approach with which to navigate these uncertain financial markets. As always, we remain primarily focused on bottom-up security selection while at the same time trying to minimize overall market risk and avoid permanent losses of capital. The cautious view that we communicated at the beginning of 2010 remains largely unchanged. As a result, we intend to maintain a low net market exposure, high levels of liquidity, and will exercise patience as we allocate capital to new investment ideas. We believe that this defensive positioning combined with our flexibility will allow us to take advantage of new investment opportunities over the coming months in what is likely to be a volatile period in equity markets.

We thank each of you for your continued support and look forward to speaking in the months ahead.

Sincerely,

Colin Stewart

John Dynes

