

VERTEX BALANCED FUND

Third Quarter Report, 2005

Even the bears are bulls! This statement would confound Darwin - but let me explain. Although it was my intention to shut up on oil, uncontrollable impulses control me yet again. It seems few analysts, pundits, investors, speculators, money managers, politicians or hookers can conceive of oil going lower. Occasionally one might come across an article suggesting that oil might fall to a range around mid \$40. These are the bears on oil – the doomsters if you will. Five years ago this would have been an analyst's wildest estimate of where the price might rise to. There's no need to go into great detail on the point being made here but the point without great detail is this: few are prepared for just how low oil could go. From 1990 – 1995, oil averaged \$20.30 and had a low of \$13.68. From 1995 – 2000, oil averaged \$19.66 and had a low of \$10.70. I do believe it's "different this time". The world has changed.....yes it has.....almost everyone believes "it's different this time", suggesting there's an awful lot of "it's different this time" baked into the Syncrude Sweet pie. How much is baked in? The TSX energy index is up almost seven fold since its low in 1999 only six years ago. That's why your fund owns no oil stocks. They could go higher but I'd prefer to own other stuff that could also go higher but has much less chance of going a lot lower.

It's time now to fess up. Mistakes....yes, uh um, well ya know, QLT yes....hummm. QLT is a Canadian based biotech company with a drug that works somewhat (but not really) to treat age related macular degeneration - blindness. The drug agencies approved QLT's product, Visudyne, largely because there was no competing therapy available and to have something that somewhat works is better than nothing at all that couldn't have worked at all. The stock was crazy expensive until this year when it finally looked as if its price made sense based on a juicy free cash flow stream. This was true until Genentech's Lucentis trials shed significant doubt on whether QLT would retain this cash flow or hand it over to Genentech in a big canvas bag. Now truth be told, your fund benefited greatly from collecting put and call premiums on QLT for the last four years, however purchasing the stock outright with the intention of being a loyal longer term shareholder was a bad idea. It was purchased for an average price of around \$14 and sold for an average just over \$11. Lesson learned – do not buy stocks like this again.

What's new then? Well lots really. In our first quarter report, there was mention of selling banks at three times book value, but this was just in jest. Shockingly, it actually happened. Bank of Nova Scotia, Royal Bank and a few others hit that metric making them unprecedentedly expensive, thus we turfed those stocks deemed too expensive for our scrooge-like investment style. Canadian Western Bank, one of our favorite companies for many years, hit a price to earnings ratio of 20X. Since its sale, it has gone up another eight bucks with a price to earnings tag of 24X – 4 multiple points above the TSX market which is in itself....expensive. Now this might sound a little broken recordish as proceeds from selling banks were moved into more P&C insurance stocks post Katrina and Rita. (Fortunately most readers will remember what a record is, but in a few years that term might sound like it came from the Canterbury Tales). These firms are

trading at single digit PE multiples and at book value with very attractive dividend yields. XL capital (yield 3%), Monpelier RE (yield 6%), and Aspen (yield 2.6%) now grace the crispy white Microsoft Excel spreadsheet displaying the valuable contents of your Balanced Fund.

Another notable mention in the Q1 report was Mattel. It was trading around \$21 and admittedly I could have been accused of being quite cocky with regard to where this stock might go but could not be fairly accused of suggesting it may fall to \$16 where it is this minute. If recollection serves me straight, one of you out there questioned one of us in here on the wisdom of owning Mattel shares when Barbie sales were clearly slowing. Well if you're reading this letter, you're right, I'm wrong at this juncture. When it comes to finding inexpensive stocks though, there usually has to be some sort of negative information everyone knows about otherwise the stock price wouldn't be attractive. Barbie certainly does seem like a bit of a "dog" these days – a little less attractive than she used to be shall we say? Let's not focus too much on the doll's looks though as that is callous and insensitive to say the least. Let's focus instead on the company's multi-brand portfolio, low PE, dividend yield of almost 3% and its debt and stock buyback program that serve to increase our wealth.

Now that we're on the subject of wealth creation and destruction, curiously, in the last few years, firms that destroy wealth the most by issuing more shares and debt to the public (wealth destruction) have seen their share prices rise dramatically, while firms buying back stock and debt (wealth creation) have seen their prices remain stagnant or fall. Say what? Yup, seen the movie before. Thankfully, after hurricanes Katrina and Rita, some insurance stocks are selling shares to repair damaged balance sheets and I guess that should be good news for your fund. Maybe their stocks will get a decent boost. It's wealth destruction but it's about time your balanced fund got in on some stock price out-performance through creative wealth destruction, although it probably only works for commodity and technology stocks.

One must remain patient and vigilant in times of grand largesse. The tables will turn just like they did in 2000. And just like in 2000 what you don't own will be more important than what you do own. If there's no longer a commodity cycle, it would be a historical first. The world's never run out of a commodity and it's highly unlikely we're running out now. The China and India thesis is becoming such a bore. Consider that last century, commodity prices dropped even as America came from nowhere to become a huge economic power. Hmmm?

Finally, after an entire career spent in the deflationist camp, I'm going to pull a Belinda and join the inflationists – at least in the short term. With high commodity prices, China is in much less of a position to export deflation around the globe. China's main cost is not labor, (it's China's big advantage) but energy and materials, and if energy, material and transportation costs are up they're in no position to reduce prices for finished goods much further. The only exception is there is still some room to move production of larger items like planes, trains and automobiles to China. On the whole though, the jig is up. If there is to be further deflation, it will have to come from improvements in technology or a drop in commodity prices or both. Anything in production in the near term will cost

more. Construction, heating oil, even paradoxically the production of energy itself is much more expensive resulting from the high cost of energy. Having said all of this, your bond portfolio has been adjusted somewhat into shorter-term bonds for the first time ever.

It wouldn't be fair to exit this letter without mentioning currency, for it has been a major drag and we're not talkin' here about the West End of Vancouver! We're talkin' about performance or lack thereof or of the negative sort. The world can now be sorted, filed, stacked and collated into two categories: commodity currencies – they're up.....and non-commodity currencies – largely they're down. Over 30% of your fund is in the latter category. This has had the effect of neutralizing gains from our brilliant stock picking south of the border. Overall, things are going well and your portfolio is in great shape to weather whatever turmoil is thrown at us.

PERFORMANCE

Net Asset Value	Rate of Return					
	<u>3 Mos.</u>	<u>Year To Date</u>	<u>1 Yr.</u>	<u>2 Yrs.*</u>	<u>3 Yrs.*</u>	<u>5 Yrs.*</u>
\$15.6373	1.75%	5.89%	14.23%	11.92%	14.72%	8.79%

*Annualized

THE PORTFOLIO

The top 20 holdings in the Vertex Balanced Fund at September 30th were as follows:

Fairfax Financial Holdings	Bank of America	Odyssey Re
CIBC	Enerflex Systems	CTS Corp.
Mattel Inc.	Partner Re	Tidewater Inc.
BCE Inc.	Kemet Corp.	Laurentian Bank
CI Fund Management	Harleysville Group	Bank of Montreal
Angiotech Pharmaceuticals	Montpelier Re	Vishay Intertech Inc.
Saxon Financial Inc.	Merck & Co.	

All bonds are government guaranteed

ASSET MIX

Cash	1%	Canadian Equities	49%
Fixed Income	25%	Foreign Equities	25%

Vertex One Asset Management