Vertex Balanced Fund Commentary:

First Quarter Report, 2005

An apology is in order. It's become apparent that I should have put your entire balanced fund into income trusts and energy shares – well not the entire fund. It's a balanced fund after all but everything outside of bonds for sure. My stubbornness not too undertake this course of action has cost you dearly. The TSX energy index was up 43% and 26% for the year ending March 31 and 5 years' annualized respectively. Income trusts have provided similar returns. One would have to be a total loser to miss out on this action but miss out I did. Maybe the root cause of this failure is in refusing to utilize newspapers for investment ideas. Have you read the headlines lately? Story after story has been and still is about oil, China, uranium, gold, the decline of America and its dollar. On top of this, if I'd just been paying attention, every story on Fairfax Financial, our largest holding, has been negative. I know this not from deliberately reading these editorials but from the emails delivered to mwood@vertexone.com subsequent to each article. Clearly, it was a sell sell sell - probably still is if one is to believe the papers. If there's any consolation…any hope in this situation we mutually find ourselves in, your fund has outperformed the broader markets over the long term despite the giant omission/s mentioned above. This might not continue to be the case if your portfolio manager doesn't smarten up and commence large purchases of those headline grabbing stocks. Certainly history has shown that our performance could have been dramatically enhanced from 1998 to 2000 had it not been for this failure to recognize the value in purchasing "headline" stocks. We missed JDS, Ballard, Microsoft, Nortel, Cisco, Enron, Worldcom just to name a few. Prior to the formation of Vertex in 1997, recollection supports missing BreX and many other newspaper darlings some of which remain listed on the exchanges even today, albeit at dramatically lower prices than 1995.

If the reader noticed a touch of sarcasm in that first paragraph, well then the reader was paying attention. Money is made in the short run on popular stocks but usually feel good money earned from ownership of popular stocks is given back along with some part of the original savings in the long run. To understand where this is going, five years is a very very short period when applied to investing as has been proven every cycle, whether it be a tech cycle or commodity cycle or whatever cycle. Because cycles are on the table now, it's appropriate to contrast a cyclical stock with those less cyclical ones. The first give away sign of a cyclical stock is extreme excitement or extreme non-excitement in an industry or sector where the stock is found – kind of a love it then hate it thing going on. The reason for this is simple. As one money manager put it recently with reference to oil companies, "They are making buckets of money". This kind of thinking pushes prices for oil shares very high and indeed everyone feels good. Then the thing happens. Could be anything. The stocks fall and investors start looking for the "buckets of money" surely these buckets are still around regardless of what thing happened. Unfortunately the buckets will be found, oh ya, but they'll be empty and with further investigation it will be determined that the buckets aren't even owned by the company …….they were leased! The money was poured back into the well in the form of more drilling, more compression and the like. So the thing that makes for a cyclical is that it has no free cash flow over a cycle. Free cash flow is what the company can pay to investors in the form of a dividend for use to buy back shares in the market. If a company has no free cash flow over a cycle, the stock price cannot rise in the long run. It is just an entity spending as much as it earns. It is simply existing like Jabba the Hut. Don't misunderstand, the stock prices can see spectacular runs as the underlying product or commodity is in demand but these runs are used by management to sell more shares to the public. Rarely do these firms use the run up in their earnings to buy back shares or raise dividends paid to shareholders. They can't. The capital, and then some, is required just to keep the business entity alive and pay back the debt loads taken on during the trough in a cycle.

A less cyclical business and I say less cyclical because every business is somewhat subject to better or worse times, will rarely get people excited enough to either love or hate them. There are few potential overnight doubles from the less cyclical businesses thus a distinct lack of press. Their cash flow is too transparent and it's such a bore. Obvious is to see they will just plod along making reasonable free cash flow and use it to repurchase stock and raise dividends. There is a trick here. I said there are no <u>overnight</u> doubles. There are however doubles over a full cycle and permanent doubles too. Have you ever heard – "hey buy CIBC, I think it's a double," your penman hasn't. The truth is, the banks have given long-term investors doubles and doubles again all the while paying dividends, dividends and more dividends. Since 1995, CIBCs dividend has gone from .74 to $2.20. Shares outstanding have <u>decreased</u> from 438 to 348 million outstanding. The stock price has largely moved commensurate with its earnings, dividends and share buybacks. Had you purchased CIBC 10 years' ago, your dividend yield on purchase price (around $16.00) is…….14% and your stock is up 4.5 times – a double and a double. I can't wait to sell it at 3 times book value and 20 times earnings but doubt the opportunity will present itself. These boring stocks never get the excitement premium that cyclicals do so we'll just keep on holding. CIBC has raised its dividend every year since it was purchased in 1998. Enough to put you to sleep that is. How consistently boring. Yawn. How about Mattel? Ever heard of Fisher Price, Barbie, Matchbox cars and Tyco Toys? Dividends have gone from 5 cents to 45 cents since we purchased it in 2001 for around $15.00. Shares outstanding have decreased through buybacks and most importantly debt has been reduced by over half to $600 million from over $1.2 billion. The stock is now at $21 and it's not a stretch, considering Mattel's economic performance, to see the stock price rise from here. How absolutely boring - Yawn again. It's too safe, too easy and too boring for most, but for my pocketbook and temperament, just right. There's no telling where these stocks are going but the businesses are sound, strong, have staying power and don't rely on selling shares to the public to survive.

One could make an argument that income trusts do pay out a very attractive yield and thus are highly qualified investments for your fund. Find me a couple income trusts that aren't selling units out of treasury every year and I'll be very interested. Only when investors and income trust mutual funds stop buying the massive load of units being sold out of treasury will the story be complete – that is whether cash is really there to pay those distributions or the cash raised in new issues is being cycled into paying distributions and/or the company is cannibalizing itself. In terms of valuation, doing the math on a number of companies your fund holds, by turning them into income trusts and giving them comparable yields to existing trusts, a number of our holdings would be doubles, some triples <u>overnight.</u> This math is quite revealing and suggests a large disparity of value and margin of safety in your fund and conversely margin of risk within the income trusts.

So why not just throw in the towel and buy energy stocks and income trusts? Money managers don't exist to make people rich. Money managers should be protecting and growing hard earned savings. Anyone can gamble in the stock market. Certainly money managers shouldn't be paid to do this. Avoiding unpriced or unrecognized risk is the job at hand. The next time someone tells you it's all about China or gold, oil or tech or all about any theme or industry, consider this: It's all about avoiding anything that it's "all about" cause that's where the un-priced and unrecognized risk is.

PERFORMANCE

Net Asset Value	Rate of Return: 3 Mos.	1 Yr.	2 Yrs.*	3 Yrs.*	4 Yrs.*	5 Yrs.*
$14.9233	**1.05%**	**5.79%**	**20.73%**	**9.91%**	**10.09%**	**9.69%**

*Annualized

THE PORTFOLIO

The top 20 holdings in the Vertex Balanced Fund at March 31th were as follows:

Fairfax Financial Holdings	Bank of Montreal	CTS Corp.
CIBC	Enerflex Systems	Tidewater Inc.
Mattel Inc.	TSX Group	Laurentian Bank of Cda.
Northbridge Financial	Partner Re	Canadian Western Bank
CI Fund Management	Kemet Corp.	TD Bank
Norbord Inc. (formerly Nexfor)	Emera Inc.	Manitoba Telecom
Bank of Nova Scotia	Sun Life Financial	

All bonds are government guaranteed

ASSET MIX

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

Vertex Balanced Fund: Performance Statistics Link

Vertex One Asset Management Inc, 1920 – 1177 W Hastings St., Vancouver, BC, V6E 2K3
P: 604.681.5787, F: 604.681.5146, E: invest@vertexone.com