VERTEX BALANCED FUND

First Quarter Report, 2006

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No Choice But to Leave Canada

***To the Editor*:**

Having just completed my master's degree in economics at Queen's University, I am beginning my first search for a fulltime job. Looking for work during a time of double-digit unemployment and full-scale corporate downsizing is daunting in itself, but there is something else that discourages me even more: Canada's public debt. If I choose to pursue my career in Canada, I know I will likely be burdened throughout my whole working life with my share of over $600 billion we owe as a country. The anticipation of this financial burden is what is causing me, regretfully, to turn my attention to finding employment in the United States.

It's not that I don't like my country - in fact, I care for it deeply. But if I stay, I will become one of a new generation of hard-working middle-class income earners saddled with the crushingly high taxes that will be needed to service the debt. I don't feel personally responsible for my country's financial situation; I was too young to vote for the governments that created it. Accordingly, I don't feel I should be held responsible for spending my career paying the debts of my predecessors. So I look south for work.

Recent columns in your newspaper, such as those by Diane Francis and Rod McQueen, have helped me reach this decision. Your faithful reporters have warned me time and time again that a Canadian debt crisis of monumental proportions will occur some time in this decade. I have learned from your journalists that even if the federal deficit can be eliminated immediately (something Finance Minister Paul Martin is giving us no indication of doing even over the long-term), our debt will double by 2003 at average borrowing costs of 7%. By contrast, it will be the year 2031 before our nation's GDP doubles in size. To bear such a burden, Canada's taxes must increase. But they cannot, because higher taxes will cause more recession, more tax evasion and the exodus of even more businesses from our country. "The only alternative is to inflate - or to let deficits run so high that the dollar collapses," writes Francis in her book, A Matter of Survival: Canada in the 21st Century. The end result will likely be a debt crisis reminiscent of that experienced by Mexico in 1982, I am told, a catastrophe that will obliterate the savings of the captive middle class. I find it difficult to feel anything but despair at the thought of starting a career here with such a dismal future in store for me.

With regards to Francis and McQueen, please don't shoot the messengers; they are simply reporting the facts. It is only fair that I should be warned in advance of my country's impending bankruptcy, the creation of which has been the fault only of my country's government.

What breaks my heart is knowing I have no sane choice but to leave the country I love, the place where I was raised and educated, and my close friends and family, simply to establish a career. Maybe, if I'm lucky, all my Canadian friends will come along with me.

Signed X

The writer's name has been withheld to protect him/her from ridicule, however, if one remembers the daily headlines back then, it would be difficult to feel any different than this young man/women at the time. What are our worries today in Canada? Answer: None. Canada is booming. No one talks about the national debt anymore or anything else for that matter. All focus is south of the border on America's national debt, deficit, impending bankruptcy and currency crash.

News alert!!! Gross debt (total debt by all levels of government) as a percentage of GDP (the national income), which is the only worthwhile measurement of a country's debt relative to its income, was lower in the US than Canada in 2005. Here are the numbers for last year: Canada 78.7%, USA 61.9%. Also US GDP per capita has been growing faster than debt per capita for decades. The last time I went into a bank looking for a loan, these are the stats my banker reviewed to assess my credit worthiness. The concept of income to debt is more important than total debt. It's interesting to note, though, on a per capita basis we Canadians are carrying $33,023.82 of debt and Americans are carrying only $27,664.32. Our GDP per capita is almost equal. Canada has come down from over 100% debt to GDP to under 70% at time of writing but I think that proves a very important point – a country has the ability to improve its balance sheet and income statement and the USA has a long way to go to get anywhere near the mess Canada was in. You'd never know it for the rhetoric though. I'm not much for economics but I highlight these statistics just to get us past the headlines that tend to shape our current thinking yet inevitably lead us to most erroneous conclusions.

Now for first time readers or those of you not paying attention for the past eight years, the Vertex Balanced Fund's mandate has always been to manage downside risk and let the upside take care of itself. Upside tends to show up over longer periods whereas downside usually shows up very quickly – sort of like how the fastest sports cars can go from zero to 60 MPH in under four seconds but when they hit a transport truck head on doing 60 MPH, their speed instantly goes to about negative 50! Also those of you who know us know also that we don't spend any time predicting the direction of markets etc. I'm sad to say though that this time is different. I know, I know, it's never different this time but hear me out on this one – humour me please. The reason I say such a thing is this: The TSX index (the Canadian market) consists of 10 sectors or industries. Three of these sectors now represent 75% of the market – Energy 30%, Materials 15% and Financials 30%.

Financials is also largely weighted in banks at 56.5% of the index. This transpired over the last five years as these industries have enjoyed excellent revenue and earnings, although I must add that a plethora of energy and material companies remain somewhat earnings challenged….well not so much earnings challenged as they have taken an oath of earnings celibacy. The problem I have is the market capitalization of firms representing these industries has grown at a far greater rate than the revenue and earnings. A similar phenomenon transpired with companies like Oracle, Microsoft and Cisco prior to 2000. For example, the Canadian banks used to trade at 1.5X book value. Now they trade at 3X book value. Energy and material firms have seen similar if not greater price to value expansions. This is a clear danger signal and danger is something I like to steer clear of. You've long known your balanced fund hasn't owned commodity related shares for reasons mentioned in many past letters but removing Canadian banks is something completely new. Gone are the cheap valuations and the controversy around bank earnings volatility. It seems Canadian banks can do no wrong today. There are, however, some risks I'd like to highlight: The first is lack of lending standards. People are mortgaged to the hilt on very expensive real estate. I can remember vividly the hoops I jumped through to qualify for a first mortgage and car loan. It used to be like a strip search at the Mexican border. Now it's "would you like a martini with that mortgage sir?" And that's for recent university grads. Today, money is flowing from the banks. They require less equity and less income for any size loan/mortgage. The second is the amount of revenue derived from investment management and brokerage not to mention all the Income Trust financings. My contention here is that earnings and revenue seem to be more exposed to the retail book than the corporate book and this is supposedly less risky, however the rub is that the retail business has become much more risky. The third is derivative exposure. This risk is very hard to measure. A brief read of the section of Warren Buffet's annual report relating to unwinding a derivatives book provides some insight and it's not pretty. I'm not suggesting an imminent collapse but merely suggesting that only return is priced into these stocks and not the risks. We'll leave these expensive firms with little perceived risk for others.

Enough of what's not in your fund, let's talk about all the stocks with lots of perceived risk priced in yet no perceived possibility of return – the inverse of the Canadian market. The most obvious of these are the Property Casualty insurance companies which we've mentioned before yet are more compelling today than ever. The risks seem so high now that everyone who follows the sector has become a weather expert. There are even economists weighing in on predictions of hurricanes in the Gulf and bla bla bla and how that's going to effect the production of oil and oil prices in the future – amazing, truly amazing. It's uncanny how proficient analysts are at projecting the most recent past into the future. The Canadian dollar is going to par cause that's the direction it's currently headed, oil's going to $100 cause that's the direction it's currently headed. We can only expect more catastrophic hurricane seasons cause we've just had two back to back. The most predictable feature of capital markets is analysts' predictions of a recurrence of last year's events. Anyway here's the way I see it: 1. Insurance pricing in the gulf has gone through the roof meaning that insurance firms have priced into their policies the last two years' devastating hurricane seasons. 2. Investors have priced into P&C insurance stocks the risks of increased hurricane activity as well as many other potential hazards.

This has left P&C insurance firms trading at a little more than book value with price to earnings ratios in the single digits. This is the antithesis of how Canadian banks are priced. Your fund owns the following P&C stocks: Montpelier Re, XL Capital, Northbridge (repurchased after a recent dramatic decline in price), Partner Re, Harleysville Group, Odyssey Re and Fairfax Financial. To conclude with these bad boys, they are priced for awful news. Bad news might occur or it might not. If it does the stocks are priced for it already. If it does not…well we both know where the stocks are going and that is north baby!

So what else? Well we got some Pharma-tech that's a cross between biotech and pharma. The list is as follows: Merck, Bristol Myers, Angiotech and QLT yet again. These stocks used to be very expensive, now they trade in low teens price to earnings ratios. Remember that Merck didn't seem risky at 40 times earnings but it's perceived to be risky now at 15 times. Go figure. QLT wasn't expensive at $100 when the analysts loved it but it's expensive now at $8.75 – try to find an analyst with a buy….NOT. It's a cash flow machine with potential for restructuring or buyout. How about Intel? No one could get enough of it at 60 times earnings and $70 a share, now they can't get rid of it fast enough at 15 times earnings and $19.75 a share. I love it.

Outside of the banks another stock that's been let go is CI Financial. This stock has been very generous to your fund to say the least. Our original cost base was under $4 a share, it was disposed of at $15 or so at the peak of the tech bubble, repurchased under $10 after the tech bubble and sold for $27 recently. I'm sorry though, I can't get my mind wrapped around the concept that a company selling for $27 a share is somehow worth $40 a share as an income trust. Note to any investors listening – if this is true then all Canadian stocks are dramatically under priced and income trusts are fairly priced or all Canadian stocks are fairly priced and income trusts are dramatically over priced. In any event, it's the ultimate arbitrage opportunity for anyone with their eyes open. Hello!

If there is one central message here it is this: An investor can now cross the border and buy with reckless abandon, Johnson and Johnson, United Technology, GE, Honeywell, Microsoft, Intel, Oracle, Merck, Pfizer, Walmart, Boston Scientific, all the P&C guys mentioned earlier and many, many others. These are firms that used to sell at high price to value metrics but now are cheaper than almost any Canadian stock - with more stable businesses, global reach and equal to greater growth rates. Your fund doesn't own all of these companies but for a patient investor, one could buy the lot of them, go to sleep and wait. Most don't have the patience though as herd behavior tends to drive people to chase recent returns rather than quality companies at attractive prices. Ah, what can I say - Darwin is ever present.

Whether I'm right or wrong won't really matter to your fund. If I'm wrong, your fund will continue to do well regardless. Our companies and strategies are doing fine, pay good dividends and egregious stock lending fees and for the most part are in the black. If I'm right though, it's not going to be pleasant for those Canadian return chasers. Hey, like the guy who wrote the letter earlier said…"Don't shoot the messenger."

PERFORMANCE

Rate of Return (Class A)

Net Asset Value	**3 Mos.**	**1 Yr.**	**2 Yrs.***	**3 Yrs.***	**5 Yrs.***	**7 Yrs.***
$13.87	**2.96%**	**7.18%**	**6.48%**	**16.03%**	**9.50%**	**11.50%**

***Annualized**

Past performance is not indicative of future results
All data are based on the Class A unit values

THE PORTFOLIO

The holdings in the Vertex Balanced Fund at March 31st, 2006 include:

Fairfax Financial Holdings	Bank of America	Level 3 Comm.
BCE Inc.	CTS Corp.	Bristol-Myers Squibb
Mattel Inc.	Harleysville Group	XL Capital Ltd.
Partner Re	Kemet Corp.	Intel Corp.
Montpelier Re	Seamark Asset Mgmt.	Vishay Intertech Inc.
Angiotech Pharmaceuticals	Sceptre Asset Mgmt.	Northbridge Financial
Odyssey Re	QLT Inc.	
Merck & Co.	Saxon Financial Inc	

ASSET MIX

Cash	0%	Canadian Equities	39%
Fixed Income	25%	Foreign Equities	46%

Vertex One Asset Management