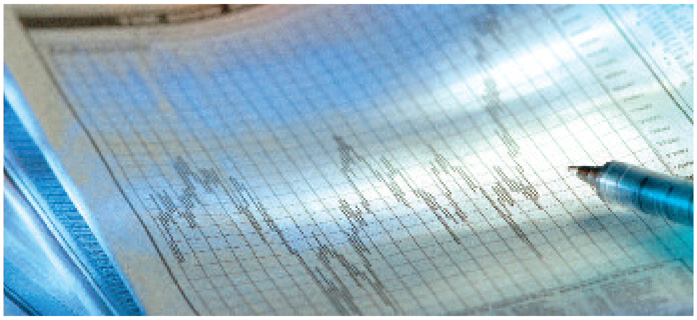
GoodFunds

GoodQuarter

AUTUMN 2008



"What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. So if you wait for the robins, spring will be over."

- Warren Buffett, October 16, 2008, *Op-Ed, New York Times*

Dear Valued Client,

It is not easy being an investor or a portfolio manager during uncertain times such as these. Watching massive declines in the share values of quality companies each day – along with all the terrible news about the global economic environment – takes its toll. We have analyzed research hypothesizing about the market's capitulation point (or bottom) five times over the past seven weeks. Each of these studies has been backed by historical data and written by esteemed individuals. So far, they have all been wrong. The decline in the stock market in such a dramatic and rapid fashion is without modern day precedent.

Although there are still many unknowns, what is clear is that the world economy will continue to contract as companies and consumers grow increasingly starved of capital. The stock market is normally a predictor of such events, as the valuations of companies drop on looming economic weakness.

It is evident that the widespread and significant fall in the valuations of great companies has been overdone. We believe the rapid decline in stock prices has already accounted for the bleak near-term future, and more. This is not to say there will be no further market declines. The remainder of the year will likely see ongoing volatility as tax-loss selling sets in, corporate deleveraging continues and investor psychology continues to drive irrational investment decisions. It is important to note that the stock market is a leading indicator of economic recovery, and thus we will see strength in equities before the actual rebounding of the economy.

One role we play in your investment success is to help you ignore the detrimental effects of emotion, and to stay calm and rational when making investment decisions. For those with long-term investment horizons, now is an excellent time to invest additional capital by purchasing great companies in these weakened markets. History has shown that investors who stay the course in times of adversity have the greatest chance of long-term investment success. GFI Investment Counsel ("GFI") will stay the course.

What we are doing right now:

1. GFI is using this time to review our holdings and ideas, and ensuring we do not own stocks in companies that will struggle through an economic downturn. We are selling any weak legacy positions at a tax loss for use against past and future gains.
2. We are purchasing shares in quality companies we believe are trading at bargain prices. Please give us a call at 1.866.955.5300 if you would like to invest additional funds at today's depressed valuations.
3. We are not selling out of panic. Our high-quality holdings pay attractive dividends and should rebound in due time. Investors who stay in the market over the upswing, when it does occur, will be pleased they did so.

As always, we ask that you contact us at 1.866.955.5300 with any questions or concerns.

Warm regards.

Daniel Goodman, CFA
President and Chief Investment Officer

How Did We Get Here?

Part I – Mortgage-Backed Securities

For those who have been glued to their television sets watching economic events unfold — but still don't fully understand how we got here — the following is a quick summary of the problem:

1. U.S. mortgage brokers obtained mortgages from American consumers and got paid a handsome commission for each mortgage generated. American banks would then lend these consumers money to purchase their new homes. Intuitively, one would assume that banks are very concerned about getting their loans repaid. The banks, however, after lending homeowners funds for their mortgages, would turn around and sell these loans to Wall Street investment banks. The Wall Street banks soon owned a basket of mortgage loans from which they collected monthly payments. Wall Street subsequently sold the loans to investors (hedge funds, money market mutual funds, etc.) through a pool of mortgage-backed securities ("MBS").

2. Investors who became concerned about the credit risk of these mortgages were reassured that the MBSs were creditworthy, and were backed by rating agencies such as Moody's and S&P.

3. As it turned out, the analytical work of these agencies was superficial. Many of the mortgage borrowers were not creditworthy, and investors were stuck owning mortgages that were not being repaid.

4. Each intermediary in this cycle earned large commissions for their role. Mortgage brokers were selling more and more mortgages to buyers that were less and less creditworthy. As the greed escalated, the requirement of a 20% down payment for mortgages was overlooked, and soon even income requirements were overlooked. Essentially, anyone could get a mortgage on the belief that home prices would always increase and, in a worst case scenario, the holder of the mortgage could sell the house at a profit, pay back the mortgage, and evict the defaulting homeowner.

5. Since the mortgage brokers, banks, and Wall Street earned enormous commissions for lending increasing amounts of cash, and did not absorb any of the losses, the incentive was to continue selling "product" or mortgages.

6. In early 2007, this house of cards collapsed. Homeowners began defaulting on their mortgages, and investors, Wall Street, and the commercial banks were no longer willing to purchase additional MBSs. Because of their existing activity, all the intermediaries carried a substantial amount of these mortgages as "inventory."

7. Wall Street investment banks and commercial banks were left with assets (MBSs) that are not worth very much. In fact, MBSs are quite illiquid and their value is currently approaching ten cents

on the dollar. Thus, American (as well as European) banks have suffered tremendous losses on their mortgage assets and the ability of the financial system to survive this crisis has come into question.

As a side note, Canadian banks largely keep their mortgages on their own balance sheets. This — coupled with a more conservative approach to home ownership by Canadians — has mitigated MBS losses on this side of the border.

Buying a CDS is akin to "Buying insurance on the Titanic from someone on the Titanic."

– Nassim Taleb

Part II – Credit Default Swaps

In simple terms, a credit default swap ("CDS") is an insurance policy written on credit without the appropriate reserves or capital to ensure an eventual payout.

Wall Street's use of CDSs has grown exponentially over the past decade. There are two primary uses of the CDS, which we have illustrated in the examples below:

1. An investor purchases $1,000,000 in five-year bonds of company A, with a coupon of 8% (assuming a purchase price of $100). A CDS is then issued and purchased to insure the holder of the bond in the case of bankruptcy. So for $20,000 (or 2% of the face value), an investor insures that they will recoup any losses on the bond if company A defaults on the bond. The net return on the bond, if held to maturity, is reduced by the premium paid to purchase the CDS.

2. A speculator does not own the bonds of company A, but believes company A may file for bankruptcy or default on its bond. The speculator purchases the same CDS at 2%, and then sells it at a higher value once the underlying creditworthiness of the business deteriorates.

CDSs are transferable, so that if the speculator is correct, he or she can sell the CDS to another speculator or bondholder who is looking to insure the same risk, but at a higher price.

In theory, the practice of buying and selling CDS contracts adds to investors' flexibility. The problem arises when the seller of the CDS is not creditworthy him/herself. Imagine insuring your home with your plumber rather than with a large reputable insurer like Berkshire Hathaway or Canada Life. The results can be disastrous. Nassim Taleb, author of *The Black Swan*, recently suggested that buying a CDS is akin to "Buying insurance on the Titanic from someone on the Titanic."

Wall Street and commercial banks insured their exposure to MBSs by buying CDSs from anyone and everyone. What they thought was insured, however, was actually very much exposed.

The complexity and intermingling of all these assets created uncertainty and possible calamity among the world's largest banks.

Fearing the unknown at American banks, GFI Investment Counsel decided not to invest in these banks. While we are still suffering from reductions in the prices of our holdings, we are happy to have avoided the loss of permanent capital because none of our businesses have failed.

GFI Investment Counsel and GoodFunds

GFI Investment Counsel ("GFI") is a discretionary money manager that provides tailored investment portfolios based on each client's unique risk level.

GFI is a bottom-up, long-term investment firm that invests primarily in North American public markets. GFI will, however, invest outside North America when quality opportunities arise. GFI meets with the management teams of prospective investments whenever possible, and places a high degree of importance on the quality and experience of these management teams when making investment decisions.

In January 2008, GFI launched Good Opportunities Fund (the "Fund"), an alternative investment fund that is the first of the "GoodFunds" series of investment products. The Fund will invest in opportunities that exhibit a high likelihood of outperforming the broader equity markets based on GFI's proprietary research, while maintaining a focus on profitable, growing companies that adhere to GFI's strict value discipline.

For more information about GFI Investment Counsel, the Good Opportunities Fund, or GoodFunds, please call **416.488.8825** or email **info@goodfunds.ca**.

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