MALACHITE AGGRESSIVE PREFERRED FUND

Monthly Report, December 2001

The fund gave up a portion of its earlier gains in December, closing the year with a monthly return of -2.54% and –2.12% for the fourth quarter. However, with a return of 8.90% in the nine months since inception, the fund has shown excellent results and we remain confident regarding the future.

Month	MAPF Total Return	NB-50 Total Return
April, 2001	+1.11%	-0.32%
May	-0.20%	-0.66%
June	+2.56%	-0.62%
July	+1.40%	+0.48%
August	+1.74%	+1.13%
September	+4.20%	+0.51%
October	+1.25%	-0.06%
November	-0.81%	+0.98%
December	-2.54%	-0.14

Quarter	MAPF Total Return	NB-50 Total Return
2Q01	+3.50%	-1.59%
3Q01	+7.50%	+2.12%
4Q01	-2.12%	+0.78%

The yield curve made some interesting shifts in the month, as summarized in the table. While the focus of this month's report will be on the "retractability spread" and its effects on returns, it is notable that the "Floating Rate Spread" widened from –0.97% at the end of November to –1.26% at year-end. This implies that the Canadian Prime Rate, which determines the amount of dividends paid on these instruments, would have to increase quite substantially from its current level of 4% in order to justify the current prices of the shares in this group. This should not be taken as a blanket condemnation every floating rate issue since relative valuations can be well out of line with the group average, as implied by the table of best and worst monthly performances.

Curve Attribute	November 30, 2001 (After Tax Figures)	December 29, 2001 (After Tax Figures)
Base Rate	3.35%	3.33%
Short Term Premium	-3.37%	-3.47%
Short Term Decay Time	4.5 Years	4.7 Years
Long Term Premium	1.63%	1.77%
Long Term Decay Time	16.6 Years	16.9 Years
Interest Income Spread	0.38%	0.46%
Cumulative Div. Spread	0.00%	-0.01%
Split-Share Spread	0.06%	0.25%
Retractability Spread	-0.42%	-0.49%
2nd Tier Credit Spread	0.10%	0.19%
3rd Tier Credit Spread	1.20%	1.10%
Floating Rate Spread	-0.97%	-1.26%

The group returns for the month shows the immense differences in performance that can arise between risk groups. Of particular note, and the highlight of this monthly report, is the enormous difference between returns for retractable issues (an average of +0.45%) those that did not share this attribute (returning an average of –1.38%).

Risk Factor	Returns for "True"	Returns for "False"
Retractable	0.45 ± 1.22%	-1.38 ± 3.01%
Split Share Corp.	-0.20 ± 1.33%	-0.21 ± 2.35%
Cumulative Dividends	-0.04 ± 2.18%	-0.40 ± 2.27%
Payments are Dividends	-0.34 ± 2.24%	1.46 ± 1.35%
Credit Class 2	-0.31 ± 2.02%	-0.12 ± 2.39%
Credit Class 3	-0.07 ± 2.63%	-0.22 ± 2.16%
Floating Rate	-0.54 ± 2.70%	-0.13 ± 2.10%

It may be useful to review the concept of retractability. Hymas Investment Management Inc. considers an issue retractable if there is a definite date beyond which the holder may be assured that the issue need not remain outstanding. Some issues, such as those issued by certain split-share corporations and all preferred *securities* (which make payments of interest, rather than dividends), are considered retractable in the analysis due to a definite maturity date, but most issues considered retractable are defined as such due to the fact that the holder has an option, at some definite date or dates in the future, to force the issuer to redeem the shares; that is, to pay the holder cash for the holdings or to exchange it for common stock in the corporation at a favourable price (generally 95% of the market price). It is clear that this attribute, which places a floor on the price at which the issue may reasonably trade, is worth some money to the investor; determining just how much it is worth is a major element in the analysis of relative value.

As shown in this month's chart, the value ascribed by the marketplace to this attribute increased substantially during December 2001, with the yield given up by investors in order to hold shares with retraction privileges increasing to over one-half of one percent (measured in after-tax dollars for Ontario's highest marginal rate) before rebounding shortly prior to year-end. This is a significant change from the lowest yield give-up on the year of less than one-fifth of one percent recorded in July.

It should be noted that we calculate the value of this attribute after accounting for its effects on the expected future cash flows of the instrument. If the marketplace did a similarly rigorous cash flow analysis of the instrument, then the expected value of this attribute would be close to 0, as the only thing to account for would be the chance that the cash flow projection was incorrect. Hence, in order to understand the valuation of the "retractable attribute" we must understand the sources of error in the cash flow analysis. Foremost among these sources of errors is the chance of future changes in the level of interest rates. We do not "take a view" on future interest rates for several reasons:

- The degree of imprecision in guesses of future rates is so large as to reduce the utility of these forecasts to a number smaller than the inherent inefficiency in the marketplace. How many forecasters predicted on December 31, 2000, that the Canadian Prime Rate one year in the future would be 4%? Even this example is a mere one year; the cash flow analysis can extend for up to 30 years.
- "Taking a view" on interest rates will introduce a huge bias into portfolio selection: a view that rates will increase substantially will, *ceteris paribus,* lead to a portfolio clustered around the short end of the yield curve. This amounts to one

big "bet". Such a "bet" can indeed produce substantial excess returns if it turns out to be correct; but equally substantial losses if wrong. At Hymas Investment Management we recognize that we will be wrong on a substantial portion of our conclusions and prefer to spread the risks in the portfolio to allow our expectation of being right most of the time to work properly in favour of the client.

- The expected turnover in our portfolios is high due to the extreme inefficiency of the marketplace and therefore changes in interest rates will be reflected gradually in the portfolio without the need to take a position in advance. In other words, it is not necessary to forecast that a particular issue will appreciate in value by 50 cents a year hence if there is an another issue that is $1 cheap now, which can be bought now and sold in the near future when it approaches fair value.
- The bias introduced in "taking a view" will favour certain instruments over others; hence trading opportunities may be lost due to, for instance, an instrument that is $1 cheap now not being bought because the view states that the current price will be "fair" one year hence. Even if the view is correct, it is more likely that the issue price will return to "fair" prior to the "fair" price falling to the current price.

Finally, we present our table of the best and worst performing issues for the month. Of

TSE Ticker Symbol	Total Return, December 2001	Remarks (Valuation commentary based on Ontario's highest marginal tax rate)
AR.PR.B	4.94%	Small, low volume issue
BPP.PR.M	4.52%	Low volume, floating rate
ENB.PR.C	4.22%	Interest Paying, very expensive at $26.75
NA.PR.I	4.06%	Redeemable, extremely expensive at $26.90
BBD.PR.B	3.97%	Floating rate, not retractable
…	…	
TFC.PR.A	- 4.53%	Floating Rate, not retractable
BNN.PR.B	- 5.21%	Floating Rate, not retractable
POW.PR.B	- 5.30%	New issue, not retractable, cheap at $22.50
NRD.PR.F	- 5.98%	Floating rate, not retractable
PWF.PR.F	- 11.68%	New issue, not retractable, extremely cheap at $21.02

particular interest this month are the worst performers, specifically POW.PR.B and PWF.PR.F. Both of these are recent issues, having started trading on November 28 and November 30, respectively. It would seem that they were issued at too high a price for the market to digest and have fallen substantially in price as the underwriters and new-issue "flippers" (those who buy new issues in the expectation of quick gains) moved heaven, earth and their sale price to get them off their books prior to year end. We commenced buying these issues shortly before Christmas at $22.45 and $21.50 respectively; although PWF.PR.F continued to fall it has recovered in early January and our analysis indicates it will prove to be a fine investment.

James Hymas, CFA
Portfolio Manager

Retractibility Premium for 2001

Data are shown for investors in Ontario's highest marginal tax bracket