Annual Report

The Goodwood Fund
1998 Annual Report

To the Unitholders of The Goodwood Fund:

For the year ending December 31, 1998, **The Goodwood Fund** (the "Fund") returned **2.45%**. The TSE 300 Total Return Index ("TRIN") dropped **1.58%** in the same period.

From October 31, 1996 (the commencement of the Fund's public operations) through to December 31, 1998, the Fund has returned **43.2%** (or **50.9%** before performance fees) versus the TRIN's return of **20.2%**. *

Through to the end of March 1999, the Fund has generated a **19.5 %** per annum compound rate of return versus **8.87%** for the TRIN.

The highlight of 1998 was the Fund's strong defensive performance (primarily due to our short sale positions) during the swift, albeit brief, market meltdown. Between May and August 1998 the TSE 300 Composite Index dropped **27.5%** while the Fund actually rose **2.33%**.

Our 1998 return was composed of **–15.7%** from our long positions and **+18.2%** from our short positions (net **2.45%**).

As a result of there being no meaningful net capital gains, dividends and interest income during the year, the Fund made no dividend distributions in 1998.

The Fund's 1998 audited financial statements and a copy of the portfolio as of April 9, 1999 are attached for your review.

** Note that the indicated rates of return are the historical total returns over the periods noted, including changes in unit value and reinvestment of all distributions. These indicated rates of return do not take into account any redemption charges that may have been payable by redeeming unitholders, which would have reduced the returns of redeeming unitholders in certain circumstances. Please refer to the Offering Memorandum for details concerning the redemption fee schedule of the Fund. In addition, note that performance data represents past performance and is not necessarily indicative of future performance.*

Investment Philosophy: Portfolio Composition

During 1998, the Fund averaged a 104% invested position (i.e., long positions plus short sale positions as a percentage of the Fund's equity averaged 104%). At one extreme, we were 182% invested (139% long and 43% short). At the other extreme, 52% invested (42% long and 10% short).

As at April 9, 1999, the Fund is 93% invested – composed of 80% longs and 13% shorts.

Our net market exposure (i.e., longs minus shorts as a percentage of Fund equity) has averaged **51%** in 1998. Thus, on average during 1998 the Fund has had only half of its capital exposed to a downward market move.

While the Fund does not have a formal target ratio of percentage invested and percentage allocated to longs versus shorts, effort is made to maintain some balance of longs and shorts (with a preference for long ideas) and to not be highly leveraged.

Investment Philosophy: Stock Selection

The Fund's operating philosophy can best be described as ... Buying good businesses at reasonable prices and short selling troubled companies at unreasonable prices.

So, what then is a "good business"? My definition includes the following key attributes: a **consistent positive** return on invested capital and, a **high** return on invested capital. In terms of prospective purchases, the Fund places a higher value on a consistent 20% per annum return on equity than on an uncertain 50% return on equity. In baseball parlance, the Fund is attempting to hit "singles" and "doubles" not "home runs".

In addition to quantum of return on capital, much thought is given to the quality of earnings. Generally Accepted Accounting Principles ("GAAP") allow for creativity in reported earnings. In some cases, large consistent earnings may be shown that are much more a function of accounting than reality. On the long side, the Fund avoids such situations in favor of substantial, recurring cash earnings.

The combination of high quality, sustainable earnings and an inexpensively priced stock is available only infrequently (usually after a corporate mishap – a missed quarterly earnings projection, an unexpected lawsuit, etc.). But, the wait is worth the while as the potential reward for betting against knee-jerk reactions can be sizable.

We are currently invested in or have been investigating numerous such opportunities including: Husky Injection Molding Systems Ltd., Dalsa Corporation, SMED International Inc., DataMirror Corporation, Future Shop Ltd., Fairfax Financial Holdings Limited, ATS Automation Tooling Systems Inc. and, Alliance Atlantis Communications Inc.

In stark contrast to our long ideas, our short sale positions feature very uncertain business futures (low or negative returns on invested capital), leveraged balance sheets (further exacerbating the paltry returns on invested capital) and “cash burns” (the company’s operations are expected to generate less revenue than expenses for some time to come).

Expectations and Rate of Return:

To avoid any potential misunderstandings, I want to stress to you that I have no idea what the Fund’s rate of return in any one year period may be. Stock investing, which for the Fund is the same as business investing, does not lend itself to accurate predictions of returns. What should be expected is to earn a return over the long run that is above the risk free rate of return (that of treasury bills issued by the Federal Government) thus justifying the extra risk incurred.

My hope is to average 20%+ per annum, not every year - just average, which, if it is achieved, will be a mix of good years and bad years. And to be clear, I am shooting for a good year in 1999 and every other year.

<u>The Fund's "Core" Positions:</u>

The Fund's core positions each typically account for 5% or more of the Fund's portfolio. A core position is one in which I have a high conviction level and am prepared to wait for some time for the stock price to catch up with fair value.

In last year’s Annual Report, I discussed six core ideas (four long and two short). As a good discipline and so you can see my “batting average” in picking stocks, I review each of last year’s selections here:

Longs:

Mainframe Entertainment, Inc.: Cash is king! We would have been far better off if we had stayed in cash (footnote to the author – never assume that profits will follow no matter how much your kids like the product!). In retrospect, a track record of earnings is hard to overemphasize.

Hudsons Bay Company: I admit to being dead wrong here as well. But, to my credit, I recognized that the “Bay” was having trouble early enough to limit our losses. In fact, I switched to being short leaving us with a small net gain.

Canadian Medical Laboratories Limited: Unspectacular in 1998 but great so far in 1999 – the stock has risen from $6.90 at the end of 1998 to $13.25 as of April 7, 1999! **Chapters Inc.:** Flat in 1998 and so far in 1999 but, still good potential.

Shorts:

Royal Oak Mines Inc.: A good call. Royal Oak is essentially bankrupt. Unfortunately, we were restricted in our exposure by the inability to borrow stock (you have to borrow shares from your broker to short sell and if too many people try to borrow at the same time - there may not be enough stock to go around. I estimate that we would have had at least twice our exposure if there were no borrowing restrictions).

Crystallex International Inc.: Also a good call and we were able to maximize our exposure. Crystallex accounted for a large portion of our +18.2% return from short sales in 1998.

Looking Forward:

You will notice that this year's Annual Report does not list any "Core" short sale ideas. I am working on some new ideas currently but haven't found any truly convincing situations yet.

Many of you are probably wondering what's holding me back from shorting all of these expensive internet stocks. The answer is equally weighted between a stubborn desire to have several important ingredients in a short sale position (not just an expensive valuation) and, in a low tolerance for pain (watching the continuing major upward moves in these stocks leaves me at a loss for words).

As an interesting aside, and in one of the few cases where I will subject you to my macro economic thinking, a business acquaintance of mine quite logically pointed out that "Mr. Market" must be wrong somewhere – either in the valuations he is ascribing to the internet stocks or in the valuations he is giving the traditional components of the economy. To a large degree, absent any major upward changes in the rate of GDP growth, any business gains (as opposed to stock market gains) made by internet based businesses must come at the expense of traditional businesses. But, while we have seen large upward moves in internet stocks, we have also seen upward moves in the shares of large, traditional businesses.

Logically, either Mr. Market is wrong on his valuations (my guess is that he is wrong in the valuations he is currently willing to place on the internet stocks) or the internet will drive a far higher rate of GDP growth than any of us have experienced to date in North America. My money (and yours coincidentally!) is on the former not the latter.

The following discussion of the Fund's core positions includes estimates of future results and target prices that are, except where otherwise indicated, based on my analysis of publicly available information respecting such companies. There can be no assurance that such results will be obtained or that the market value of such securities will approximate their target prices.

<u>Drug Royalty Corporation Inc. ("DRI") – common shares:</u>

DRI creates and acquires royalty interests in pharmaceuticals. The Company may: i. Provide funds to life science companies in return for royalties; ii. Acquire existing royalty streams from public institutions, inventors or companies; and, iii. Acquire intellectual property rights - which can be licensed for royalties.

A change in senior management at DRI seems to have unleashed some new earnings potential. For the last few years DRI sat with an excessive cash balance as it struggled to create royalty opportunities to invest in. With the addition of Ian Lennox as President and Chief Executive Officer, DRI seems to have hit it's stride. The company has moved from $15 million in book value of royalties (and $42 million in cash) as of February 28, 1998 to $48 million in royalty book value (and $2.3 million in cash) as at February 28, 1999.

DRI's earnings per share ("EPS") should rise materially as it is expecting to achieve a minimum 20% per annum internal rate of return ("IRR") on it's royalty investments (in fact, their experience to date suggests a greater than 20% IRR is being achieved). This compares with an approximate 4% rate of return earned on its cash balances.

I expect DRI to generate EPS of $0.18 per share in fiscal 2000 (August fiscal year end) and that the stock could be valued between 15X and 20X EPS.

Target Price: $2.70 to $3.60 per share.

<u>Leon's Furniture Limited ("LNF") - common shares:</u>

LNF is one of Canada's leading specialty retailers – specializing in furniture, home appliances and consumer electronics.

LNF has an enviable track record of generating consistent and substantial returns on shareholder's equity despite carrying a large cash balance and utilizing no leverage (excess cash/underleverage act as anchors on a company's return on equity but are signs of fiscally prudent management).

The future looks equally as promising as LNF's new store formats are resulting in quicker investment paybacks. Furthermore, as the traditional main line department store chains continue to scale back their operations, more home furnishings market share is becoming available for LNF (management estimates their current Canadian market share at just 7% - leaving plenty of room for growth).

With approximately $5.00 per share of cash, a current stock price of $17.30 and $1.50 to $1.60 in EPS in 1999 (perhaps $2.00 in EPS in 2000), the stock is inexpensive.

Target Price: $25 per share.

Canadian Medical labs common ("CLC") - common shares:

CLC has been a major position for the Fund beginning in 1997. As of April 9, 1999 it accounts for **14%** of the Fund's equity value.

Beginning early in 1999, the rationale for owning CLC has begun to be justified. CLC's core lab business provides the Company with a platform of substantial free cash flow, which the Company can reinvest in higher growth opportunities (specifically the pharmaceutical research business).

Further strengthening CLC's earnings power is the recently announced acquisition of the assets of bankrupt MedChem Laboratories Limited ("MC"). This purchase will likely be highly additive to CLC's earnings as MC's quota of lab work will be performed through CLC's existing facilities.

Earnings projections (by both analysts and management) that factor in the MC acquisition are calling for incremental earnings per share of $0.40 to $0.45 in fiscal 2000 (September fiscal year end) indicating that $1.25 in fiscal 2000 earnings seems feasible. The non-lab operations, which are currently not contributing much in the way of earnings, may be worth $2 to $3 per share.

Target Price: $20 per share.

Please call if you have any questions, thoughts or comments.

Peter Puccetti, CFA
Chairman & Chief Investment Officer

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