GOODWOOD INC.

THE

GOODWOOD

FUNDS

2003 Annual Report
Eighth Edition

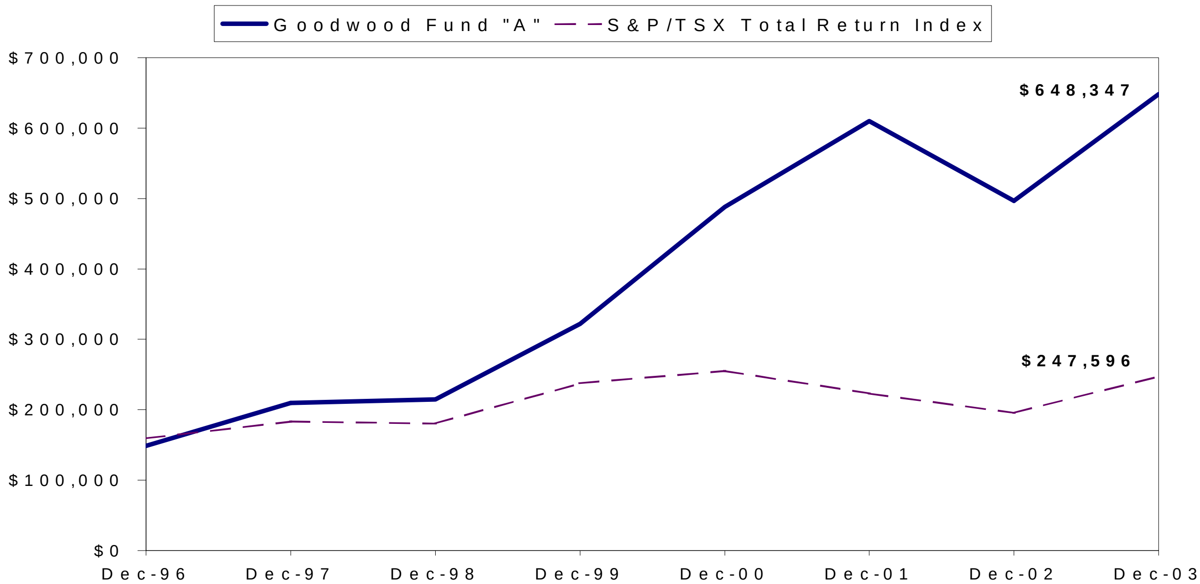
Goodwood Inc.
Introductory Letter

The twelve months of 2003 returned to our unitholders strong results in both the Goodwood Fund and the Goodwood Capital Fund surpassing our long stated goal of achieving a 20% average annual rate of return. In particular, the Funds benefited by the significant discounted valuations of our core holdings being reflated (albeit rather quickly) to levels that, in our opinion, more accurately price their current business value. Not surprising with a rising equity market, investors' sentiment has reversed from a state of despair to a mood of confidence -- how quickly things can change.

The Goodwood Fund (long/short) returned to unitholders net **30.5%** for the Class A and **27.9%** for the Class B. The Goodwood Capital Fund (long only) returned to unitholders net **32.8%**. In comparison, the S&P/TSX 300 Total Return Index ("TRIN") appreciated by **26.7%** and the S&P 500 Index gained **26.4%**.

At the risk of being repetitive to our long-time unitholders, it is important to emphasize that we are and will continue to be value investors. Goodwood's strategy to achieve above-average long-term performance can be sustained by purchasing equity in a few companies at market prices significantly below our assessment of their current business value. Each and every day we are judicious in our outlook for companies that are financially healthy, possess redundant and/or unrecognized assets, and are managed by quality people. Conversely, we will seek to sell short companies with an excessive market valuation relative to their true underlying value, companies that are financially vulnerable due to excessive debt, and/or have deteriorating fundamentals. Therefore, we continue to advocate that the true character of the Goodwood Fund is that of a "value fund that can make short sales".

Goodwood Fund
Comparison of Change in Value of $150,000 Investment since October 31st, 1996

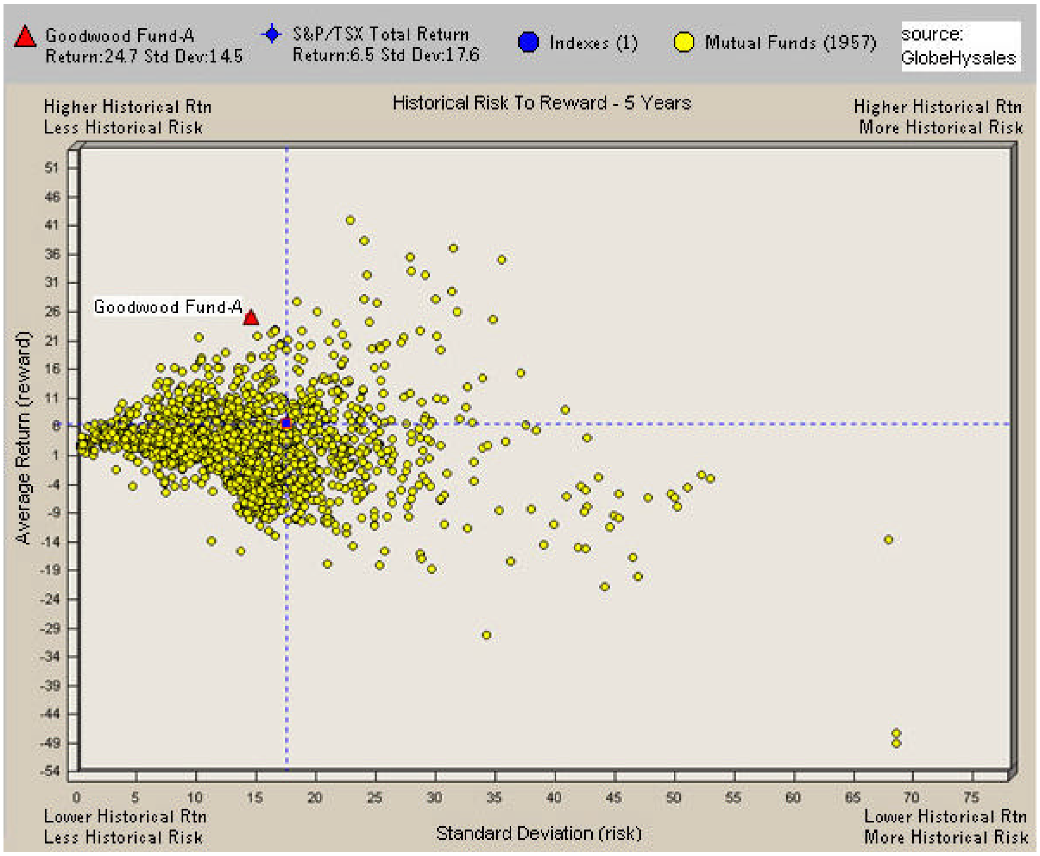


Year-Over-Year Returns

October 31, 1996	$150,000	N.A.
December 31, 1996	148,588	N.A.
December 31, 1997	209,628	41.0%
December 31, 1998	214,764	2.5%
December 31, 1999	322,253	50.0%
December 31, 2000	487,891	51.4%
December 31, 2001	609,864	25.0%
December 31, 2002	496,856	-18.5%
December 31, 2003	648,347	30.5%

The Goodwood Fund has returned to unitholders an annual compounded return of **22.7%** (net of all fees) since its October 31st, 1996 inception. Comparatively, the S&P/TSX 300 TRIN has returned **7.2%.**

Return versus Risk



The above-noted risk versus reward graph is interesting. The graph is measuring 1,957 mutual funds over five years ending December 31st, 2003. The main message here is that the Goodwood Fund achieved a net return of **24.7%** versus the S&P/TSX 300 Total Return of **6.5%**, and importantly, the Goodwood Fund achieved these results with **17.6%** less risk than the Index.

To better understand our investment approach, we continually communicate the key tenets to which we adhere:

- We are value investors with a Canadian focus;
- We are substantial investors in the Fund;
- We will concentrate our best ideas;
- We are prohibited from utilizing derivatives;
- We employ little to no leverage;
- We will communicate on a regular and candid basis.

We sincerely appreciate the ongoing support and confidence of all of our unitholders and encourage you to call me directly should you have any questions.

Respectfully submitted,

Cameron MacDonald, CFA
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March 31st, 2004

THE GOODWOOD FUND
2003 Annual Report

To the Unitholders of The Goodwood Fund:

For the year ending December 31, 2003, The Goodwood Fund’s (the "Fund") “A” unit net asset value (“NAV”) per share increased by **30.5%** while the “B” units increased by **27.9%.** The TSE 300 Total Return Index ("TRIN") increased by **26.7%** in the same period.

From October 31, 1996 (the commencement of the Fund's public operations) through to December 31, 2003, the Fund has returned **22.7%** per annum net (after all fees) versus the TRIN's per annum return of **7.2%**. [*]

The Fund's 2003 audited financial statements are attached for your review.

During 2003 (based on month end figures), the Fund averaged a **91.4%** invested position (i.e., market value of long positions plus market value of short sale positions as a percentage of the Fund’s equity). At one extreme the Fund was **107.2%** invested, composed of **89.8%** long and **17.4%** short, leaving a “net market exposure” (i.e., longs minus shorts as a percentage of the Fund’s equity) of **72.4%**. At the other extreme, **75.6%** invested – **67.2%** long and **8.3%** short for a net market exposure of **58.9%**.

While the Fund does not have a formal target ratio of percentage invested or 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 minimize leverage.

In past Annual Reports, we have repeated some basics from the “Goodwood Philosophy”. We view this as very important for our unitholders to <u>read and reread each year</u> – it provides a good overview of our style of investing and it’s in our collective interests to have an informed unitholder. Please see “The Goodwood Philosophy” attached as an appendix after this letter.

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[*] 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.

<u>What a Difference a Year Makes</u>

During this time last year, as we wrote the 2002 Annual Report, the shared investment mood in North America was almost suicidal. The Dow Jones Industrial Average ("Dow") was dropping with such frequency and severity that we began to keep track of the number of days it would take for the Dow to hit zero (calculated as the latest daily points decline divided into the Dow's then level - when times are tough, investors take to collecting market statistics with the same morbid curiosity as that displayed by any Chicago Cubs' fan). This statistic, which of course could never really come to fruition, as a Dow at zero would imply a negligible price for 30 of the most outstanding corporations in the world, bottomed somewhere around 38 days but regularly reached the low 40 day range. That's how bad things were. And, now with the benefit of hindsight, we know that March of 2003 marked the beginning of a large, uninterrupted twelve-month move up in North American indices – how ironic.

Is this the beginning of some new, sustained bull market? We doubt it. There appear to be too many valuation and macro-economic issues for this to be the beginning of something even more substantial. And, history tells us that it is quite normal for the market to rally over shorter time frames even while in the midst of a protracted multi-year period of flat to negative returns (e.g., the 1990's Japanese market and the 1970's U.S. market witnessed several major rallies during generally abysmal decade long periods for each market).

Take the above as the extent of our macro-economic soothsaying. Warren Buffet, in his 2003 Berkshire Hathaway Annual Report letter, points out that " …the cemetery for seers has a huge section set aside for macro forecasters". The thing about being stock pickers as opposed to market timers is that we're not trying to guess the direction of the next market wiggle. And, don't be fooled, no matter how eloquent someone sounds or writes about these things, they don't really know either. In fact, their success may be inversely proportional to their eloquence!

By focusing bottom-up with important consideration for the price of a stock and working to understand the hidden value in our long holdings and the misunderstood downside in our short positions, we avoid having to make gutsy and slim probability market calls. Rather, we let our estimates of fair value versus undervaluation on a position-by-position basis dictate our buying and selling (and short selling). Sometimes this leads to inadvertently making the equivalent of a market call. For example, a large part of our reluctance to short over the past year has been rooted in our bottom-up observation of the direction of corporate earnings, which seemed to us to be improving (in some cases dramatically) year-over-year. For sure we'll have situations where we are too early in buying and too early in selling but, over the long run, we believe this business-by-business approach is a superior methodology and one that eliminates emotion from the process (emotion is the arch enemy of the investor …e.g., causing one to sell when you should be buying).

Lately we've been asked repeatedly about the Fund's exposure/approach to the U.S. dollar (for those of you who have somehow not noticed …the U.S. dollar has exhibited un-U.S. dollar-like behaviour in declining measurably against other currencies). Our approach has been to try to ensure that our U.S. long positions are fully offset by our U.S. short positions. But, given our reluctance to short in the face of improving earnings and, given our two large U.S. long positions (discussed later on), this has been difficult to do. Thus, we have been running a bit of U.S. dollar exposure. We're optimistic that the rate of return of our U.S. long positions will offset any currency "hit" and then some.

Quantifying the Upside – Discount to Intrinsic Value

As we did in last year's Annual Report, we'd like to give an idea of the potential upside inherent in our current long holdings if they were to rally to our estimates of intrinsic value (i.e., their values as businesses which can differ substantially from their share prices) minus a cushion for error. Again, we believe that these estimates are conservative (which would be backed up by our historical tendency to sell too early) and they do not factor in that we may buy more of these ideas, that the business value estimates may increase going forward due to compounding of underlying earnings and, that we may find more ideas during the year. We estimate our current discount to intrinsic value to be 23% suggesting a potential upside in the portfolio of roughly 30%.

As always, we expect to take this figure higher, in particular through adding to some of our lesser-weighted existing positions and/or through the introduction of new long candidates. Adding one or two high quality ideas at a 5% plus weighting that have the potential to double (or more), would add materially to the Fund's potential upside.

Recapping Last Year's Core Positions

Also, in last year's Annual Report we reviewed our then major long holdings. The following is a quick recap of those names, some of which are still large positions for us:

CanWest Global Communications Corp.: CanWest was a major contributor to our performance last year as our original cost in the low $5 per share range compares favourably to the December 31, 2003 share price of $13.85. Through 2003 we sold approximately half of our holdings. Recently, as the stock sold off below $12.50 (currently below $12), we have begun to buy it back. Despite the Canadian TV business showing some signs of weakness, there are some potentially significant positives that could come to light in 2004 (e.g., monetization of the New Zealand/Irish properties) that would potentially lift the stock higher. Our ultimate target continues to be $2 to $4 per share higher than the current share price.

Extendicare Inc.: At this time last year, Extendicare stock was floundering at $2.80 per share down from $4.20 as at the end of 2002 and we had no brilliant explanation for this other than general market malaise. Again, what a difference a year makes. The stock is now trading for $14.90. That's a 632% move up in a year …who said value investing wasn't exciting? And, analysts' price targets are currently even higher. Our one regret is that we didn't buy more during the March doldrums of last year.

Belzberg Technologies Inc.: For the most part our investment experience with Belzberg stock has tested our patience. It has been a frustrating experience but, at the risk of sounding parrot-like, Belzberg has begun turning the corner on profitability and it continues to penetrate significant U.S. accounts. This is, in no small measure, due to its successful partnership with the Chicago Board Options Exchange. Indications are that more revenue growth and earnings are in the offing. As the company's costs are largely fixed, costs should rise much more slowly than revenues (i.e., Belzberg's estimated gross profit margin on incremental revenues above current levels is in excess of 80% - tantamount to tremendous operating leverage) and, as a result we expect a significant improvement in profitability. Stay tuned, we may yet be proved right and, possibly in a significant manner!

The Great Atlantic & Pacific Tea Company, Inc.: Clearly the company should consider a name change - we would suggest … "Not-So-Great Atlantic & Pacific Tea Company". However, the central point here is that the severely discounted stock price more than compensates for the company's problematic U.S. operations. We continue to generate a liquidation value (i.e., intrinsic value if the business were to be broken up and sold piecemeal) north of US$20 versus a current share price of US$7.67. On several occasions we have encouraged the controlling shareholder (who owns 57% of the company) to consider their options closely and to not be married to a heroic turnaround effort when there is so much latent, easily realizable value lurking in the corporate closet. We shall continue to wait it out especially as the U.S. operations are showing some signs of improvement. In this case, patience may be a financially rewarding virtue.

Dundee Bancorp Inc.: Dundee share price has exceeded the target we suggested last year of $22 per share and is now trading at roughly $27.00. This represents an 84% profit versus our average cost and roughly two year holding period. Our estimate of Dundee's underlying value has increased further than we initially expected and so, we expect a bit more in the way of share gains. However, we have sold down the position to a current weighting of 4.4%. The amount of management criticism that Kingsway Financial Services Inc. (discussed in the following section) is currently receiving is very reminiscent of what we witnessed over the last couple of years in respect of Dundee management. Hopefully, the outcome with Kingsway is at least as rewarding.

New Core Positions

Below we discuss some of the more meaningful positions currently held by the Fund.

Kingsway Financial Services Inc. ("Kingsway") – common shares:
Kingsway is a property and casualty ("P&C") insurance company focused on underwriting non-standard auto and trucking insurance. The company operates through nine wholly owned subsidiaries in Canada and the United States. Non-standard auto insurance provides coverage to drivers who find it difficult to purchase standard auto insurance as a result of driving record, vehicle, age and, claims history or due to limited financial resources. Non-standard auto insurance policies generally require higher premiums than standard or preferred auto insurance policies for comparable coverage.

Kingsway's management team continues to be viewed dimly by the Street, owing to large prior period reserve charges being taken. [When an insurance company re-estimates how much its policies will ultimately cost, more often than not needing to increase its past estimates, this is referred to as restatement of prior period reserves. This additional reserve item will show up as an extra expense in their current period income statement, even though it relates to a prior period]. The aura of mistrust that now follows management has resulted in an unusually low price-to-earnings multiple being placed on the company's stock.

However, we feel there are some counter points that should be taken into consideration when judging Kingsway's managerial aptitude. First of all, Kingsway is not alone in having set reserves for the 1999-2002 period below what has ultimately transpired, particularly in regard to the Ontario and Alberta auto business. The Insurance Bureau of Canada just released its 2003 year end survey of Canadian insurance companies which indicated that, on average, Ontario auto insurance underwriters generated claim losses and operating costs equal to $1.18 for every $1.00 of premium income (in insurance parlance, a combined ratio of 118%). Not that this excuses Kingsway's foibles but it does point out that it is an industry-wide problem. Secondly, this management team has actually produced a stellar growth rate in per share book value (one possible measure of management's track record). Since the end of 1995, its first year as a public company, Kingsway's per share book value has grown at a rate of roughly 27% per annum compounded – one of the highest rates of growth in book value per share of all Toronto Stock Exchange listed stocks during this time frame.

Whether or not the Street's distrust has been fairly earned, we have our reasons for liking the stock. Obviously, one cannot ignore the prior period reserve charges as they are a very real cost and they force an investor to be suspicious of the current period results (i.e., how do we know that the same under-estimation mistakes of past years is not also populating this year's results?). But, there are some common sense facts that lead us to believe that the current period results are not as likely to develop significant problems in the future:

1. Increased pricing and tighter policy terms, so long as they exceed any increases in claims costs, will eventually result in profitable underwriting. For example, take an insurance company that, after a couple of years of hindsight and the vast majority of potential claims have been filed and/or settled, realizes that it's pricing of two years ago has generated $1.20 in claim losses and administrative costs for every $1 of premiums taken in (a combined ratio of 120%). In other words, the company lost $0.20 for every $1.00 of insurance premiums written.

   However, as it became obvious to this company that pricing was not adequately offsetting costs, it began to both increase prices and tighten policy terms (in our example here we ignore the potentially significantly positive impact of tightening policy terms and focus just on the price impact). This company, in respect of the same policy that was priced at $1 two years ago is now charging $1.50 (a 50% increase over the two year period). So, with no further adverse change in claims and/or operating costs, this company is now in the enviable position of generating $1.50 in revenue for every $1.20 in costs (a combined ratio of 80%). We believe Kingsway is moving towards this sort of an improving situation through 2004, that the company's price increases have more than caught up with its costs.

   Given the diverse lines of business that Kingsway writes, it's impossible to pick one number that describes the pricing increases experienced across all of its lines over the last few years …for some lines it would be a doubling or more, for others much less. Suffice to say that the lines with the greatest problems have been the focus of the greatest price increases. In the aggregate, we believe that Kingsway's Canadian and U.S. businesses have experienced average premium rate increases over the last two years of 44% and 32% respectively.

2. In addition to price increases, there is considerable evidence to suggest that claims costs are no longer rising. Supporting our expectations that claims costs in Ontario auto will now level off (or even decline) are recent legislative changes geared to reducing health care and legal liability costs in Ontario. First, court award deductibles have been increased from $15,000 to $30,000 – making it more difficult for borderline claims to justify court action. This will have a significant positive spillover impact in easing out of court settlements. Secondly, amounts being paid to health care providers by insurance companies will be materially reduced. Historically, Ontario

auto insurance companies have paid substantially more for health care services than "OHIP" (Ontario Health Insurance Plan) or Worker's Compensation. They will continue to pay more under the new legislation but much less so due to a 30% to 50% already-enacted price cut for certain services. Thirdly, referral fees paid from one service provider to another (e.g., a tow truck driver receiving a fee for referring business to a particular rehabilitation clinic) are now prohibited. The preponderance of such referral fees has fanned the fraud flames and, given the heavy cost of fraud (particularly in the Greater Toronto Area), any move to interrupt the cycle is welcome.

Lastly, there is always the possibility that the relatively new Liberal provincial government in Ontario will act to curb costs even further as this could translate into lower premiums – a politically-desirable end objective.

3. Kingsway's U.S. auto business has much less per claim risk than its Ontario auto business. U.S. liability limits are typically not greater than US$40,000 per occurrence versus a typical Cdn.$1 million liability limit in Ontario auto. While Kingsway's U.S. auto business is not immune from showing adverse development (e.g., an increase in the frequency of claims can hurt too), the much lower cap per claim helps to minimize the potential risk.

So, just what is Kingsway stock worth? We suspect that Kingsway will report progressively better underwriting results through 2004. A 96% combined ratio for all of fiscal 2004 would translate into $2.38 of after-tax earnings per share. Note that this figure is higher than the 2003 accident year combined ratio of 93.1% (in other words - excluding the prior period reserve charges, 2003's results worked out to a 93.1% combined ratio). Importantly, our earnings per share estimate assumes a modest yield but no realized gains from Kingsway's approximately $47 per share in "float" (alongside the combined ratio results, an insurance company gets to earn a return on its "float" which, in simple terms, is aggregate premiums taken in which don't have to be paid out in claims for some time to come). At 10x earnings per share our target price would be approximately $24 or 60% higher than the current share price. In comparison, the P/E range for comparable U.S. and Canadian P&C companies is between 9x and 16x 2004 estimates.

For sure there are offsetting negatives which we list here:

- The possibility that the Ontario government will demand rate declines with no attempt to further moderate claims inflation through legislative improvements.
- Approximately 32% of Kingsway's written premiums are now generated from its trucking lines. Intuitively, this line of business strikes us as having a fair amount of risk. Although management is quick to point out that they have experience in writing truck insurance and that management of the subsidiaries they purchased has such experience. As well, pricing on truck insurance has moved higher over the last two to three years and, these policies are, on average, reinsured above $1 million of liability.
- Kingsway's rapid growth over such a short period of time (the company's gross written premiums has increased from $60 million in fiscal 1995 to $2.6 billion in fiscal 2003) is sure to generate some organizational issues and probably played a part in the adverse reserve development of recent history.
- Further adverse trends in claims costs. In the example we gave earlier in this discussion of the impact of a rising premium on a company's combined ratio, perhaps the operating and claims costs of our company may have risen beyond the $1.20 level.

On balance though, we feel that our Kingsway position is an intelligent investment with substantial upside and a downside that has already been largely realized. We expect relatively large earnings per share results to be released quarter by quarter through 2004.

Laidlaw International Inc. ("Laidlaw") – common shares:
Laidlaw is essentially a collection of four businesses in which each business is an industry leader in North America: Laidlaw Educational Services, a contract provider of school bus transport to municipalities; American Medical Response, a contract provider of ambulatory transport services to hospitals; EmCare, a contract operator of hospital emergency rooms; and Greyhound Lines, the widely recognized passenger bus service with the famous "running dog" gracing the side of its buses.

We have accumulated a position in Laidlaw International Inc. ("Laidlaw") at a time when the company could be considered to be "in transition". By transition we mean that the company was flying under investors' collective radar, has been difficult to understand, and consequently, under appreciated by investors. We believe that this "transition" period is nearing an end, and the company is preparing to deliver increasingly better results as its operating businesses gain momentum.

As a result of debt accumulated during an aggressive acquisition spree in the late 1990's (this could apply to a number of companies) and an accounting scandal at a principal and now unrelated subsidiary, Laidlaw filed for bankruptcy protection in June 2001. The company reemerged in June 2003 largely free of its past issues, equipped with a new management team and a recapitalized balance sheet.

Despite the stigma of a very long bankruptcy and restructuring (we should point out that, at least in financial market terms and due to the surplus of "distressed" and private equity funds which seek out such "special situations", the term bankruptcy no longer has the foul smell connotation it once had), Laidlaw's core operating businesses continue to produce. We consider Laidlaw to be an attractive investment for several reasons, all of which were recently reinforced during a visit with senior management in Chicago:

1. Several opportunities to reduce costs and improve efficiency have been identified which, when combined with modest revenue growth, will provide for increased earnings over the next several quarters. Early evidence of this appeared in the 2004 first quarter, as Laidlaw's "EBITDA" (earnings before interest, taxes, depreciation and amortization) increased 13.7% over the prior year. The company's sensitivity to cost control is very high, as a 0.5% increase in EBITDA margins (we expect multiples of that) would have the effect of increasing earnings by approximately US$0.21 per share.

2. Laidlaw generates strong, stable free cash flows that should provide the company with the opportunity to further deleverage its balance sheet. With a free cash flow "yield" (i.e., cash flow available after all expenses, interest, taxes and capital expenditures expressed as a percentage of a company's market capitalization) approaching 10%, Laidlaw should produce over US$135MM of free cash flow in fiscal 2004 to pay down debt, moving the company a long way towards its goal of obtaining an investment grade (BBB- or better) credit rating. Becoming investment grade would reduce the company's interest costs, increase its access to capital (to fund future

growth) and improve the markets and its customers' perception of Laidlaw's financial strength. Equity owners benefit disproportionately when a company reduces its high cost debt as, not only earnings increase (due to lighter interest charges), but the valuation multiple ascribed to the equity increases (due to the perception that risk has been reduced);

3. Management is committed to unlocking unrealized value through the sale or spin-off of its various businesses as and when appropriate. Given that the current market valuation of Laidlaw is well below the value of these business in aggregate (i.e., a "sum-of-the-parts" valuation), we feel that such a corporate direction is increasingly likely. This is further reinforced by an operating management compensation plan that encourages Laidlaw, the parent company, to sell and/or IPO the Healthcare businesses in advance of 2007 and for maximum value.

Based on our conservative analysis of the current value of Laidlaw's underlying businesses, we believe the share price could approach US$20. This compares well to a current share price of US$14, management's incentive plans (struck at US$13), and our average cost of US$12.70 per share. In addition, the recent listing on the New York Stock Exchange (Laidlaw's shares use to trade "over-the-counter") should increase the visibility of the company, and open its shares for investment to a new group of potential shareholders. This is often the case with a company emerging from bankruptcy. The mainstream traditional public institutional investors (e.g., mutual funds and pension plans which, despite the growth in alternative investments, are still the repositories of the bulk of investable capital) will take some time to become reacquainted with Laidlaw. Their future buying will, hopefully, provide the fuel for a return to fair valuation.

All in all, it looks like we could be in for a good ride.

Creo Inc. ("Creo") – common shares:
Creo is a Vancouver-based, international success story. The company is the world's leading supplier of prepress systems for the printing industry. Creo has over 25,000 customers and its product line includes software and hardware for computer-to-plate imaging, systems for digital photography, scanning and proofing, as well as printing plates and proofing media. Creo also supplies on-press imaging technology, components for digital presses, and colour servers for high-speed digital printers. The company's customers include commercial, publication, on-demand, packaging and newspaper printers and creative professionals.

We keep coming back to Creo as a long position in the Fund as we are drawn by the company's quality and reputation as well as its extensive worldwide customer list and its dominant market share. Ask any printer about Creo's products and chances are that they will speak highly of the company's quality. Getting a chance to purchase this sort of a business for an inexpensive valuation is a rare event. The company's book value per share is US$6.55 as compared to a current share price of US$9.50, the balance sheet features a net cash balance (i.e., cash net of all debt) of US$1.33 per share and the stock's market value (after deducting Creo's surplus net cash) is only 0.7x 2004's expected sales (fiscal year end is September 30). And, this in an industry where the comparable companies are trading for 1.4x sales. In stark contrast to its current unloved state, Creo traded for US$52 in March of 2000.

Alas, there's no free lunch here as Creo's recent performance has justified the market's skepticism.

To begin with, profitability levels have been inadequate. Creo generated a 44.6% gross margin in fiscal 2003 yet managed just a 2.2% pre-tax net margins (adjusted to exclude various non-cash charges, one time items, etc.). The discrepancy between a relatively decent gross margin (note that many technology-based companies have higher gross margins) and an almost non-existent net margin has a lot to do with Creo's massive US$79 million per annum in research and development spending (equal to US$1.43 per share pre-tax). This has been a consistent theme in Creo's expense line as US$79 million and US$73 million was spent in fiscal 2001 and fiscal 2002 respectively. While we have pressed management for a tangible answer as to "rate of return on R&D investments", none has yet been offered. Understandably, this is a difficult thing to quantify and the benefits are possibly years away from being realized.

Contributing to Creo's lack of earnings has been the company's build out of infrastructure in anticipation of revenue growth to come (e.g., selling, general and administrative costs). In addition, the rally in the Canadian dollar as compared to the U.S. dollar has hurt Creo's profitability, as a large proportion of the company's costs are denominated in Canadian dollars while a large percentage of its revenues are U.S. dollar (thus the recent drop in the U.S. dollar exchange rate had a negative impact on profitability).

There is a broader story being told in Creo's sub par results, one of secular decline in the company's traditional stronghold – the large commercial printer. These firms have been struggling with excess capacity resulting in a curtailment of their capital spending budgets. Creo's efforts to offset this trend by focusing selling efforts on growth markets (such as newspapers, packaging companies, mid-size and smaller commercial printers) and through the development of new, more affordable products, has not fully compensated.

A couple of final issues have likely contributed to the market's lack of enthusiasm. Firstly, that Creo management stumbled badly in losing out on the purchase of PrintCafe, Inc. ("PrintCafe") – a company that Creo once touted as integral to their plans to penetrate the small printer market. Despite owning 37% of PrintCafe's stock, Creo was outmaneuvered by Electronics for Imaging, Inc. as the latter successfully took over the former. Management credibility was done no favour by the prompt change in tone regarding the importance of PrintCafe to Creo's small printer market foray. A second factor would have been Creo's aborted attempt (due to "low shareholder support") to adopt an employee stock purchase plan during the February 2004 Annual General Meeting. This lack of shareholder support is completely contrary to the Board's unanimous endorsement. The point being that Creo's management and Board's credibility was again strained.

But enough of the litany of negatives, the $64,000 question is (and, in Fund's case, it is considerably more than $64,000)… what could take the stock higher? In our opinion there are two very clear, potential catalysts – a material improvement in earnings and/or a takeover offer from another company. Management's publicly-stated goal of achieving US$1 billion in revenues by fiscal 2007 - a compound annual growth rate of close to 15% per annum from fiscal 2003 revenues, would argue for much improved net profitability as the company would be able to spread its infrastructure costs much more economically over a larger revenue base. The earnings potential, should Creo actually manage this sort of revenue growth, would be substantial, almost ensuring a much higher stock price. At US$1 billion in annual revenues and assuming gross margins remain constant (i.e., maintaining gross margins at today's approximate 44% level), we believe that Creo's net earnings would be in the vicinity of US$1.60 to US$1.70 per share (after a conservatively-assumed tax rate of 30% - note that, as at September 30, 2003, Creo had US$172 million in tax loss carryforwards).

To put the impact of such an earnings level in perspective, assume a target price/earnings multiple of say, 15x. At that level and, assuming US$1.60 to US$1.70 in earnings per share, the stock could trade for US$24 to US$25.50 (between 353% and 368% higher than the current share price!).

Creo's worldwide reputation for quality, its substantial market share and its extensive customer list make the company a prime acquisition candidate for a number of other companies. Furthermore, Creo's aggressive move into the "plate" market (see discussion in next paragraph) may force the issue with some of these other companies as they may not want to lose their entrenched plate market share to Creo. We suspect that Eastman Kodak Company (which is aggressively reinvented itself as a digital printing company), Xerox Corporation (which already has a very successful partnership with Creo), Electronics for Imaging, Inc., Hewlett-Packard Company and Agfa Gevaert NV would all be interested in acquiring Creo.

In the meantime, the focus of our research is upon better understanding how Creo might generate such large incremental revenues. An important part of this focus comes down to understanding the company's strategy in now offering its customers a Creo-branded digital thermal printing "plate" (plates are the templates used to transfer ink onto the print medium during the print process). The company expects to be generating US$150 million in plate revenues by fiscal 2006, which would aid considerably in achieving the company's revenue targets. Historically, Creo had left the plate business to others preferring to focus on its strength in CTP devices (computer-to-plate). But, the foregone revenue opportunity became too big to ignore so, after much study, research and development, the company launched its own plates. Initial indications are that it is a high quality product with certain competitive advantages as compared to other offerings. In addition, Creo has over 5,000 CTP device installations, which make for a large potential customer base for its new plates. In summary, Creo believes that entering the plate business has doubled its addressable market and enhanced the company's ability to sell into the smaller printer market (as the company can now offer a total solution).

We remain somewhat skeptical of Creo's chances of actually achieving its stated goals in plate revenues however, we'll get excited (as will the rest of the Street) when and if we see meaningful revenue traction over the next few quarters. And, we're apathetic as to the source of the revenue traction.

The almost annoying thing about our Creo position is that the company could probably show a massive improvement in its earnings profile if it decided to retrench rather than expand. By cutting back on costs and squeezing the greatest amount of profitability out of Creo's existing, successful product lines, we believe the company would be following a far less risky road towards stock market respect. But, invariably (and this is an observation that is not Creo-specific) management and the Board sense a dereliction of duty if they aren't constantly priming the growth pump. Of course, a growth strategy is "potentially" more rewarding …the problem is in handicapping the odds of success. Conversely, a strategy of drastically improving profitability on existing revenues (a "bird-in-the-hand" approach as opposed to "two-in-the-bush") would be a far less risky road to take and one that would be far more immediate in terms of share impact. In fairness, this is not our only position where latent value remains latent due to management and the Board deciding that a grow and/or turn around strategy is the right course rather than a more short-term focused emphasis on immediate improvement in shareholder value (The Great Atlantic & Pacific Tea Company comes to mind).

In the event our continuing research leads to stronger conviction and/or the share price becomes even more compelling, our current 6% weighting leaves room for us to be proactive.

Finally, while liberal options awards skew their upside even more heavily in their favour, we are somewhat appeased by the meaningful amount of stock owned by top management and certain members of the Board of Directors (approximately 10% of the shares outstanding). And, this is in one class of stock rather than through a multiple voting/subordinate voting structure. Perhaps we're taking too much comfort in this but it seems to us that Creo management will consider both the downside risk as well as the upside reward through their significant ownership of stock.

Looking Forward:

As you know from past Annual Reports, we have been loath to make macro economic predictions (taking the point of view that our opinion has the same chance of being right as the majority of the population say, 50/50). Our focus continues to be "bottom-up", one company at a time.

On both the long and short side new ideas are constantly coming into view across many different sectors. As always our long emphasis will be on finding inexpensive, high quality situations that are not well followed or are misunderstood. When combined with dubious, expensively priced short positions, the portfolio has the ability to do well in any market environment.

Please call if you have any questions, thoughts or investment ideas.

Respectfully submitted,

Peter Puccetti, CFA
Chairman & Chief Investment Officer
Goodwood Inc.

March 31, 2004

The Goodwood Philosophy

Expectations and Rate of Return:

To avoid any potential misunderstandings, we want to stress to you that we have no idea what the Fund's rate of return in any one-year period may be. Stock 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 (the risk free rate of return is commonly defined as the return of treasury bills issued by the Federal Government) thus justifying the extra risk incurred.

Our hope is to average at least 20% plus per annum, not every year - just average, which, if it is achieved, will be a mix of good years and bad years.

Frequently Asked Questions:

In meeting with prospective and existing investors some common questions recur as follows:

Why do we prefer longs over shorts?

The following three reasons are key:

i. A good long idea sometimes holds the potential for a double (100% return), triple (200%) or more of invested capital, while the most one can profit from a successful short idea is 100% (i.e., the security in question drops to $0.00).
ii. Equity markets, with some notable exceptions, have tended to rise most of the time (i.e., let's go with the best odds).
iii. Other investors are likely to recognize a good long idea faster than to act on a good short idea because management is often touting the positives (and usually not saying much about the negatives). Also, there is far more investment capital geared to buying stocks than shorting stocks.

Why doesn't the Fund employ derivatives and utilize more leverage?

We are prohibited from using derivatives and we have self-imposed (and mandated by the Offering Memorandum) restrictions on our use of leverage. While very bright people can and do make effective use of large amounts of leverage and complicated derivative strategies, it is interesting to observe that the hedge funds that "self-implode" tend to be voracious consumers of these tools.

Furthermore, we have no past expertise in derivatives nor in strategies that involve borrowing large amounts. Finally, our relatively large position concentration at the top end of the Fund gives us plenty of "zing" (obviating the need for leverage) in our results.