
❖ Global Contrarian Research ❖

Report Compendium

March 2009

Featured Companies

iShares Dow Jones US Financial Sector (IYF)
Fairfax Financial Holdings Ltd. (FFH)
Groupe Bruxelles Lambert (GBL BB)
Japan Petroleum Exploration Co., Ltd. (1662 JP)

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Murray's Musings

The reason why worry kills more people than work is that more people worry than work.
-- Robert Frost

Exchange Traded Funds: Double & Triple Shorts

In one of his essays, G.K. Chesterton advanced the very interesting hypothesis that one should never argue with a lunatic, because you will probably get the worst of it. There's a certain clarity in the work of a lunatic; it's merely premise and conclusion, and reality is frequently much more complex than that. For example, if a lunatic were to assert that the entire world is but a grand conspiracy, my natural rejoinder would be that, not only am I not a member of the conspiracy, but none of my acquaintances are members either. The truly unanswerable response from the lunatic would be "What do you expect a conspirator to say?" It has its own self-validating logic.

In that vein, if one were to assert that the S&P 500, having declined by 56%, is only about halfway through its decline if one equates the current cycle to that of the Great Depression when the market fell by 80%, and if one were to further assert that an additional 50% decline would be required to arrive at negative 80, then there would be a fineness of logic to that assertion that would be genuinely unanswerable. If I were to argue the opposite position by asserting that, even if I granted that this is exactly similar to the Great Depression, from a purely arithmetical perspective, a decline of 1.2% a day for 61 days would create enough negative performance to arrive at negative 80 for the S&P. Therefore, using that as an example, we would be 61 days away from the bottom, unless the rate of diminution was greater than that.

The unanswerable response from the pessimist would be to call me an optimist, and I would lose the argument. Though I could give other examples, I'll refrain. Instead, I'll look at the world from the pessimistic perspective, which is that the return on equity for companies both private and public will plunge, and they will remain low for an indefinite period of time. There's a problem with buying commodities, because demand for commodities will decline with the decline in the economy. There's a problem with buying corporate credits and municipal securities, because the credit worthiness of the enterprises are now all called into question.

There's even a problem with buying United States Treasury securities, because the credit worthiness of even the United States government has now been called into question, as you can tell from CDS spreads on Treasuries. Even if that were not the case, there is the ever-present danger of inflation, which will erode the value of money. Of course, one can't buy

gold, because gold has increased in value so much over the last five or six years, that it's clearly a bubble.

All of the possibilities are closed, and all we can do from a public policy sense as a society is to watch the tragedy unfold. It's too late to take any remedial action whatsoever. The only approach that might be advisable would be to purchase some of the many short-oriented Exchange Traded Funds (ETFs) because, unlike all the other assets in the world, these funds have the possibility of earning an alluring rate of return. Having lost the argument, I decided that I would undertake the study of short-oriented ETFs for this week's *Musings*.

The number of short-oriented ETFs is far greater than anything I had originally believed to be the case. Table 1 contains a partial list that includes what appear to be the most popular short-oriented ETFs, followed by the volume measured in shares (as of March 6th). While the many assertions that our society is rapidly de-leveraging may be true in the world of corporate balance sheets, one can see at a glance that it is certainly not true in the case of short-oriented ETFs. Measured in volume, the most popular short-oriented ETFs are clearly those that are most leveraged. I think that's indisputable from the data presented in Table 1 (page 5).

Short-oriented ETFs have made their appearance on all the major continents, and they exist in most countries. I started to list individual Canadian short-oriented ETFs, and I was going to list similar British and other European funds, but I grew weary of the exercise. Suffice it to say that, in addition to the funds listed here, there is a variety of other ETFs that are short-oriented; for example, in Britain you'll find a company called ETF Securities.

In Canada, there is a popular series of short-oriented ETFs called the Horizon Series. I claim no relationship whatsoever to that enterprise but, since it bears the name Horizon, I thought it behooved me to list those securities that I could identify. As part of this exercise, I counted at least 33 leveraged commodity ETFs in the United Kingdom, and 35 oil exchange traded funds worldwide. The list in Table 1 is not exhaustive but, nevertheless, supports my point about leverage.

The one common feature shared by all of the leveraged short-oriented ETFs is that they all advocate the constant leverage model of investing. In that model, the short-oriented ETF engages in a series of swap transactions at the end of each trading day so that the following day it will be a multiple, in the inverse sense, of the performance of the index that it tracks. For example, a 2x short-oriented fund will transact during the course of the day, or by the end of the day, so that in the next day's trading, whatever the performance of the underlying index is, the short-oriented ETF will be the inverse of 2x that performance.



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Table 1: Short-Oriented Exchange Traded Funds		Share Volume (in millions)
	Direxion Financial Bear 3x (FAZ)	19.730
	Direxion Large Cap Bear 3x (BGZ)	13.450
	Direxion Small Cap Bear 3x (TZA)	5.730
	Direxion Developed Markets Bear 3x (DPK)	0.051
	Direxion Mid Cap Bear 3x (MWN)	0.110
	Direxion Emerging Markets Bear 3x (EDZ)	0.099
	Rydex Inverse 2x S&P Select Sector Enrgy (REC)	0.015
	Rydex Inverse 2x S&P Select Fincl (RFN)	0.082
	Rydex Inverse 2x S&P Select Tech (RTW)	0.001
	Rydex Inverse 2x S&P Select Health (RHO)	0.007
	Rydex Inverse 2x S&P Select Energy (REA)	0.004
	Rydex Inverse 2x S&P 500 (RSW)	0.532
	Rydex Inverse 2x Midcap S&P (RMS)	0.038
	Rydex Inverse 2x Russell 2000 (RRZ)	0.082
	Short QQQ ProShares (PSQ)	0.547
	Short Dow 30 ProShares (DOG)	2.000
	Short S&P 500 ProShares (SH)	4.670
	Short Midcap 400 ProShares (MYY)	0.300
	Short S&P Small Cap 600 ProShares (SBB)	0.043
	Ultrashort QQQ ProShares (QID)	28.980
	Ultrashort Dow 30 ProShares (DXD)	20.640
	Ultrashort S&P 500 PrShares (SDS)	70.310
	Ultrashort MidCap 400 ProShares (MZZ)	2.690
	Ultrashort Small Cap 600 ProShares(SDD)	0.097
	Ultrashort Russell 2000 ProShares (TWM)	7.350
	Short Financials ProShares (SEF)	0.137
	Short Oil & Gas ProShares (DDG)	0.008
	Ultrashort Consumer Services ProShares (SCC)	0.242
	Ultrashort Financials ProShares (SKF)	21.280
	Ultrashort Health ProShares (RXD)	0.058
	Ultrashort Real Estate ProShares (SRS)	20.120
	Ultrashort Semiconductor ProShares (SSG)	0.307
	Ultrashort Technology ProShares (REW)	0.352
	Ultrashort Telecommunications ProShares (TLL)	0.003
	Ultrashort Utilities ProShares (SDP)	0.030
	Short MSCI EAFE ProShares (EFZ)	0.060
	Short MSCI Emerging Markets ProShares (EUM)	0.155
	Ultrashort MSCI EAFE ProShares (EFU)	0.415
	Ultrashort MSCI Emerging Markets ProShares (EEV)	2.950
	Ultrashort MSCI Japan ProShares (EWV)	0.009
	Ultrashort FTSE/Xinhua China ProShares (FXP)	4.670
	Ultrashort 7-10 Year Treasury ProShares (PST)	0.116
	Ultrashort 20+ Year Treasury ProShares (TBT)	6.310
	Ultrashort DJ-AIG Commodity ProShares (CMD)	0.007
	Ultrashort Gold ProShares (GLL)	0.259
	Ultrashort Silver ProShares (ZSL)	0.315
	Ultrashort Euro ProShares (EUO)	0.142
	Ultrashort Yen ProShares (YCS)	0.123
	Direxion Energy Bear 3x (ERY)	2.240
	MacroShares \$100 Oil Down (DOY)	0.001
	Market Vectors Double Short Euro (DRR)	0.029
	PowerShares DB Agriculture Double Short (AGA)	0.020
	PowerShares DB Agriculture Short (ADZ)	0.001
	PowerShares DB Base Metals Double Short (BOM)	0.003
	PowerShares Commodity Double Short (DEE)	0.007
	PowerShares Commodity Short (DDP)	0.002
	PowerShares DB Double Short Crude Oil (DTO)	0.326
	PowerShares DB Gold Double Short (DZZ)	0.901
	PowerShares DB Gold Short (DGZ)	0.033
	PowerShares DB US Dollar Index Bearish (UDN)	0.458
	PowerShares DB Crude Oil Short (SZO)	0.005
	PowerShares DB G10 Currency Harvest (DBV)	0.110
Canadian	Horizon BetaPro COMEX Gold Bullion Bear Plus (CA: HBD)	0.038
Canadian	Horizon BetaPro NYMEX Crude Oil Bear Plus (CA: HOD)	1.900
Canadian	HorizonBeta Pro NYMEX Natural Gas Bear Plus (CA: HND)	0.109
Canadian	HorizonBeta Pro S&P/TSX 60 Bear Plus (CA: HXD)	1.890
Canadian	HorizonBeta Pro S&P/TSX Financials Bear Plus (CA: HFD)	0.188
Canadian	HorizonBeta Pro S&P/TSX Global Gold Bear Plus (CA: HGD)	2.140
Canadian	HorizonBeta Pro S&P/TSX Global Mining Bear Plus (CA: HMD)	0.008

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One of the unquestionable mathematical consequences of the constant short-leverage model of investing is that when the index reaches a bottom, if it ever does, the maximum amount of short exposure is achieved there, not at the top. The constant ratio short exposure is what an experienced short seller would do if he or she believed that a given company was going bankrupt because, as a company declines in value, the exposure is lessening. To maintain constant exposure, measured as a percent of one's portfolio, one needs to short ever more securities as the price declines. At any point in time, it has the interesting arithmetical attribute that the return is always 100%, based, of course, on the assumption that the security will decline to a value of zero.

For example, a security with a price of \$20 that declines to \$10 has produced a 50% rate of return, but would, at that price, offer the portfolio only half the exposure it enjoyed at a price of \$20. Therefore, the number of shares would have to double for the portfolio to have the same exposure. Whether viewed from a point in time when the price was \$20 or when the price was \$10, the potential rate of return was always 100%. It's a bounded rate of return, unlike in a long investment for which the potential rate of return can be infinite. Ironically, the potential loss on a short sale can be theoretically infinite, although it's rarely infinite, but the profit is always bounded by 100%.

Another observation is that leveraged short-oriented ETFs invariably do not realize good long-term rates of return. For a classical example of that fact, one can study the performance of the short-oriented financial funds for the year of 2008. The financial indices declined enormously, but the returns realized by the short-oriented funds for those indices were not very large, the reasons for which are several-fold.

There are certain transaction costs that inure to the fund resulting from the need to continually rebalance. More important is the danger of the constant leverage model as evidenced by the huge losses that were realized on the swap positions of financial sector ETFs when those stocks rebounded late in October 2008. As the index increased in value, in order to maintain the constant leverage model, the funds had to reduce their exposure. As the index rose, the exposure was reduced and, therefore, even when the index began to descend again, the fund didn't have sufficient exposure to regenerate the returns, given that a certain amount of capital had been lost.

In light of the situation just described, one would think that the leverage model would not be popular with investors, but quite the contrary is true. The popularity of the 2x leverage model was surpassed when the 3x leveraged funds were unveiled. The 3x leveraged funds have proven to be even more popular than the 2x leveraged variety. The Direxion Financial Bear 3x ETF trades 19.73 million shares a day at a price of \$104.07, based on the Friday, March 6, 2009 closing price, which equals \$2.05 billion. However, that truthfully isn't the proper measure of the dollar volume *versus* the share volume of that fund, because the nominal value, given the 3x leverage, is 3 times \$2.05 billion, which is \$6.15 billion of daily trading. That's the amount of money that is actually at risk.

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To put that figure in its proper context, the daily trading value of Exxon, the largest company on the S&P 500, measured in dollars, is only \$2.7 billion. Since Exxon is one of the most popular stocks traded in the United States, I think that it is legitimate to assert that the Direxion Financial Bear 3X ETF is quite a popular security that has obviously captured the imagination of the investment public.

I engaged in another exercise to select financial companies, and to measure their daily trading volume during recent days with a view to arriving at a figure, on a cumulative basis, that's more or less equal to the \$6.15 billion of trading value of the Direxion Financial Bear 3x ETF mentioned above. Taking the sum of the entire daily volume value of the securities listed in Table 2 (below) results in a total of \$6.121 billion. The Direxion Financial Bear 3x ETF which, interesting enough, is not the only inverse financial fund in existence, has a daily trading volume value equal to that of eight of the largest financial services companies in existence. Therefore, I think it's fair to say that the short interest dominates.

Table 2: Daily Trading Volume Value

	(\$ in millions)
Bank of America	\$891
Wells Fargo	\$955
JP Morgan	\$1,226
Citigroup	\$280
American Express	\$190
Morgan Stanley	\$628
Goldman Sachs	\$1,650
US Bancorp	\$301
Total	\$6,121

To understand this point further, the entire leveraged "bet" of the three popular financial short leveraged ETFs listed below in Table 3 is the sum of their trading volume value, which is \$16.8 billion, or about 2.75 times the amount of daily trading volume value of the eight largest financial services companies, and 6.22 times that of Exxon.

Table 3: Daily Trading Volume Value

	(\$ in millions)
Direxion (FAZ)	\$6,150.0
Rydex (RFN)	\$13.6
ProShares (SKF)	\$10,640.0
Total	\$16,803.6

There are certain mechanics to the creation of leveraged inverse ETFs that should be discussed and understood. Viewed from the point of view of the investment public, it is undertaking a hedge against presumed ownership of financial stocks or, alternatively, it is

undertaking a direct investment. It's hard to know what the motivation of the traders in these investments are, but I would dare say it's much more likely to be the latter rather than the former. The character of the underlying index has undergone a dramatic shift in the last year and a half.

For purposes of illustration, I'll use the iShares Dow Jones US Financial Sector (IYF). As can be seen below in Table 4, due to the decline in Citigroup's market capitalization, it comprises only 0.77% of IYF at the moment. As the leading banks fall in value, others that are not necessarily leading companies, become greater and greater proportions of the IYF index and, therefore, effectively become subject to short-selling volume.

Table 4: DJ US Financial Sector (IYF)

	% Value of IYF
JP Morgan Chase	8.65%
Bank of America	2.76%
Wells Fargo	4.45%
US Bancorp	2.17%
Citigroup	0.77%
T. Rowe Price	0.76%
PNC Financial Services Group	1.00%
BB&T Corp.	1.00%

For example, BB&T Corporation is a bank that, as far as I can tell, has very little, if anything, to do with credit default swaps, subprime lending or any of the other dangerous forms of portfolio exotica. In spite of that, BB&T now represents 1% of the IYF financial index. I presume the situation for the others is similar. On February 24, BB&T raised its dividend. It has a market capitalization of \$7.7 billion, and shareholder's equity, or book value, of \$16 billion; therefore, it trades at slightly less than 50% of book value.

As far as I can tell, BB&T is a top tier performer that appears to be gaining market share. Its provision for loan losses is 1.62% of loans, its Tier 1 risk-based capital is 12% of total assets and its net interest margin is 3.68%. As I noted previously, it appears to have no involvement with toxic assets but, unfortunately, it does have involvement with the index. As a consequence, as it has achieved a greater percentage of the index, it inevitably became subject to short-selling pressure, and it has declined by 50% in the first nine weeks of 2009.

PNC Financial Services Group also represents a 1% position in IYF. Though PNC's prospects are perhaps not as interesting as BB&T's, I've yet to see anyone assert that it is a future Citigroup. Yet, PNC is down over 60% year to date. US Bancorp, with its 2.17% weight, has almost the same weight in the index as Bank of America, and finds itself under

pressure. At the moment, Wells Fargo represents 4.45% of the index; historically, it represented a smaller weight.

If this trend continues for very many weeks, these banks will have proportionally smaller weights in the index; therefore, within the financial services indices, non-banks would have the greater weight. People would find themselves in the position of shorting an index for a perceived characteristic that the index would no longer have. It's the sort of situation that you find in bubbles when people ignore reality.

This mechanism is not dissimilar to that of credit default swaps (CDSs). The credit default swap mechanism, a major cause of the economic problems of the world, is really a form of leverage. There's much more notional amount to a CDS than there is to the debt that a CDS insures. Therefore, as the credit spread widens, the CDS liability increases disproportionately, and results in a requirement to post collateral. The collateral post itself widens credit spreads, because the liquidity of the various participants in the credit default swap market is now somewhat called into question. The credit spread widens, causing the CDS liability to rise, creating the requirement post more collateral, which further widens the credit spread. It's a continuous feedback loop that goes on until an external force disturbs the inertial forces.

On Friday, March 6, 2009, one such external force appears to have been introduced in the system when the credit default swap clearing arm of the Intercontinental Exchange was granted permission to begin operations on Monday, March 9, 2009. In the short run, very little should be expected of this for several reasons. First, the sheer magnitude of the credit default swap volume means that it will be some time before a meaningful number of credit default swaps are cleared through the system. When enough of them have been cleared, the money from the collateral posts that is currently trapped in escrow accounts will be freed. The clearing mechanism for CDSs will not be radically different from the one for commodity futures. Collateral will readily flow through the counterparties rather than be immobilized in escrow accounts. Therefore, even very dramatic moves, positive or negative, in credit spreads will not lead to a liquidity drain the way they have been.

Reasonable minds and observers may dispute the actual notional amount of CDSs. There are some who say the notional amount is only \$33 trillion; others assert that it's as high as \$48 trillion. There are other estimates as well but, if one examines the magnitude by which credit spreads have widened during the last nine months, one can imagine what percentage of the notional amount of CDSs is now trapped in escrow accounts for collateral purposes. Irrespective of the numbers one uses, that amount is clearly a major proportion of the money supply of the world that was drained from the liquidity of the system. Clearing of CDSs on an exchange proposes to reverse that process.

The Europeans have not announced their choice for CDS clearing. Intercontinental Exchange asserts that it will be ready to clear for European CDSs at the end of the first half of the year. The regulators say that within not very many months, the Europeans will

follow the Americans by instituting CDS clearing. This process is likely to change in the not-too-distant future, and people should take note of it.

Regulators might wish to subject leveraged ETFs to the net asset test provisions of the Investment Company Act of 1940. That Act provides that no fund registered under the SEC can have an asset to borrowings ratio of less than 200%. ETFs are launched under special regulatory exemptive relief and, as such, they are not subject to the Act's guidelines. If the regulators were to demand compliance with the net asset test provisions of the Act, it would do much to protect the public.

At the end, there will be a denouement when the indices will bottom, and there will be maximum exposure at the very moment when the index has an enormous upward move. If the underlying indices have a move not dissimilar from the upward move in the summer of 1932 when the Dow Jones Industrial Average bottomed, the losses could be staggering. The author Robert J. Shiller notes in his book called *Market Volatility* that the Dow Jones Industrial Average increased by 83% month-to-month between July and August of 1932. The Dow Jones in that era was at least a diversified index, whereas the financials are in a non-diversified index that is probably very dangerous to be short.

Industry Thoughts

iShares Dow Jones US Financial Sector (IYF)

I would like to recommend the ETF called iShares Dow Jones US Financial Sector (IYF). I'm quite willing to grant the possibility that all the major banks will be nationalized. Let's assume that Citibank were to be nationalized, which would result in its shareholders being completely eviscerated. From the point of view of the IYF index, that would only represent a loss of 77 basis points (Table 4 is reproduced below for reference). Given the index performance experienced so far, I don't think that the index investors would be unduly discomfited by that thought.

It may well be that Bank of America would be nationalized as well, in which case the shareholders would have a similar experience, because it only comprises 2.76% of the index. Losses of that size are generally experienced by the financial sector index in an hour. I suppose the fate of Wells Fargo might be debated, but let's assume that Wells Fargo was eviscerated as well. It would be a 4.45% loss. That leaves JP Morgan Chase, which most observers say is unlikely to be nationalized, because it will probably meet the tangible net worth tests of the Treasury Department's stress test to be conducted shortly.

Table 4: DJ US Financial Sector (IYF)

	% Value of IYF
JP Morgan Chase	8.65%
Bank of America	2.76%
Wells Fargo	4.45%
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Citigroup	0.77%
T. Rowe Price	0.76%
PNC Financial Services Group	1.00%
BB&T Corp.	1.00%

If we assume that perhaps 7-odd percent of the index will be eviscerated, and all the rest of the index trades at an unduly low valuation, one can imagine what might happen. Various companies, of which US Bancorp is an example, have been cutting their dividends with the object of redeeming the government investment. The TARP money has stigmatized those who accepted it, because it is generally referred to as a bailout, and the only people who need a bailout are those who are technically insolvent. The Treasury Department obviously realized this when the TARP funding was granted and, not wishing to stigmatize any one bank, it asked, and perhaps insisted, that many banks that didn't really need TARP money accept it.

US Bancorp is one of those that didn't need it. If some banks are destined to fail the net worth tests, there are other banks that are destined to pay back the TARP money and not be stigmatized. On the other hand, BB&T (mentioned in the *Musings*) has no intention of paying back the TARP money. It does not feel itself stigmatized, unless one considers the stock price. BB&T intends to lend that money out. In the current environment, as the leading banks find themselves in disarray and seek to downsize their balance sheets, BB&T has been gaining market share.

There is another interesting statistic in relation to this industry that should be quoted. Many observers have noted in various periodicals that 61% of all subprime loans are adjustable rate mortgages (ARM). Therefore, it is asserted that once those mortgages reset at the higher rates, the United States will enter yet another cycle of diminishing home prices and defaults, because the resets will be at higher rates. The resets will occur in the next three years.

Since so many people have made the above assertion about the ARM statistic, and it is a very worrying statistic, I decided to research it. It is indeed accurate that 61% of all subprime loans are adjustable rate mortgages. According to a publication of the U.S. Federal Reserve dated January 2009 called *Credit Conditions in the United States* (<http://www.NewYorkFed.org/regional/subprime.html>), it is true that 61% of all subprime loans are ARM. At January 31, 2009, 16.1% were scheduled to reset within 12 months, 3.6% reset within 12-24 months and 2.9% reset thereafter.

Let us assume that the first category resets within the 12 month period from January 2009 to January 2010, and are ratably distributed throughout the year. We have no reason to presume otherwise. Of the 16.1%, 2.68% will already have reset by March 31, thereby leaving a total of 13.42%. I think the same logic could be applied to the other temporal categories. It's interesting to see how the data is presented in the media. I think it's very clear from the data that, more or less, 80% of all the resets have already occurred. At least insofar as the data is concerned, we're not at the beginning of the reset process; we are at the end of the reset process. If 80% of the resets have not destroyed the American economy, it's hardly likely that the remaining 20% will do so. I'm recommending this industry group.

Featured Companies

Fairfax Financial Holdings Ltd. (FFH)

Fairfax Financial is a Canadian company managed by Prem Watsa, a controversial figure whom many regard as the Warren Buffett of Canada. At the moment, this company's shares trade at a 14% discount to book value. The 23-year record of book value growth at Fairfax is 25% per annum, which exceeds the Berkshire Hathaway record.

To the credit of Fairfax Financial, until very recently it had a very large Credit Default Swap (CDS) position in subprime, which is to say that it was short subprime mortgages, or short the ABX. The company benefited mightily from that position. Some years ago, Fairfax Financial bought a series of problematic insurance companies, and three years ago the investment community was greatly concerned that those purchases would soon render Fairfax Financial insolvent.

Three years ago the company traded at a greater discount to book value than it currently does. At that time, believe it or not, a shareholder could lend out Fairfax Financial shares to be shorted, and be paid 30% per annum interest, because they were hard to borrow. By way of validation, since records aren't kept of the borrow expense, one could look at the put option premiums applied to Fairfax Financial three years ago to see why somebody would pay that rate for borrowing the shares. The implied volatility of Fairfax Financial was one that makes the current level of the VIX look like a placid investment environment.

During the course of the period from late 2008 to early 2009, Prem Watsa began to change his investment posture. He concluded that, while a year and a half ago the market had erred on the positive with respect to real estate, it now errs on the side of caution. He transferred his positions from being negatively oriented to being positively oriented. Specifically, he purchased Johnson & Johnson, Kraft, and \$700 million worth of Wells Fargo stock, which has declined precipitously in the last three months or so. He also moved most, but not all, of his U.S. Treasury portfolio into the U.S. Tax-Exempt portfolio, and he repurchased shares of his stock at \$284. The stock price is now 20%-plus lower than his repurchase price.

The market now regards these investments as highly suspect and ill-considered. The market marks the book value to market each day, which is possible since many of the investments are publicly traded, and their nature is well known. To the extent that Fairfax Financial bought \$700 million worth of Wells Fargo, at the moment it has clearly lost a very substantial portion of that investment. Fairfax has also lost a lesser percent, but no less grievous amount, in Kraft. There have been some losses in Johnson & Johnson, in addition to other security positions that have rendered losses.

I personally find the position of the market to be nothing other than predictable but, nevertheless, incorrect. This is one of those opportunities when one can buy a high quality company with a high quality management at a discount to book value, and I think the opportunity should be taken.

Groupe Bruxelles Lambert (GBL BB)

Groupe Bruxelles Lambert is a Belgian holding company that, at the moment, trades at a 23% discount to net asset value. This company makes opportunistic investments, and it's concentrated. At the moment, the investments are largely Total Petroleum, Imerys and Lafarge, which is a large cement company and, therefore, is cyclical. It also holds two versions of Suez: GDF Suez, which is Suez merged with Gaz de France, and shares in the spun-off Suez Environmental, a water treatment company. There's also the Spanish utility holding company, Iberdrola, and an investment in Pernod Ricard.

There are also a number of private equity investments, specifically, three private equity partnerships: PAI Europe, Sagard Private Equity, and Ergon Capital Partners. Many of the investments in these private equity funds are inherently cyclical businesses and include steel roofing, doors, door manufacturers, window manufacturers, glass container manufacturers, etc. Imerys is also a cyclical company, as is Lafarge. Total is cyclical for entirely different reasons, because it's an oil company and its profitability depends on the level of oil prices, to a large extent. The market participants have clearly decided that these investments on the part of Groupe Bruxelles Lambert are rather ill-considered and ill-conceived. Therefore, the investment community has decided to assign an increasingly greater discount to net asset value to the shares of Groupe Bruxelles Lambert. It could be valued, readily speaking, on any given day.

A large percent of the Groupe Bruxelles Lambert shares are held by a holding company that trades in Switzerland known as Pargesa (PRGAF). The Pargesa shares trade at a substantial discount to the Groupe Bruxelles Lambert shares that it holds, plus there are some other equity investments. Groupe Bruxelles Lambert could be said to have a double discount when viewed through the prism of Pargesa, which might be a better way of owning Groupe Bruxelles Lambert.

The company could improve its valuation in the market by merging the two holding companies together, an idea that is not in any way farfetched, since Groupe Bruxelles Lambert has a history of such actions. For example, in a prior era, Groupe Bruxelles Lambert holdings were held in a Belgian holding company by the name of Electrafina. Almost a decade ago, the company undertook to eliminate the Electrafina holding company discount by merging Electrafina and Groupe Bruxelles Lambert. It's not without precedent if they were to take that action again.

I think that this company presents an interesting opportunity. I'm much more inclined to think that the managers of this company have sensibly invested the company than that the investment community has logically graded the company. Therefore, I'm recommending Groupe Bruxelles Lambert for the first time in about nine years.

Japan Petroleum Exploration Co., Ltd. (1662 JP)

Japan Petroleum is the national petroleum company of Japan and, for many years, it was an arm of the Japanese government. The company was privatized in 1970. Its mission is to assure the continual flow of oil to Japan. This company's valuation statistics might be extraordinary when viewed in the light of history but, given the state of the Japanese market, they are by no means extraordinary from the point of view of Japanese equities. To begin with, Japan Petroleum trades at nearly 50% of its book value. The company's market capitalization is all of \$2 billion, and net current assets, expressed in dollars, are \$690 million. The stock trades at a 10x P/E ratio. The balance sheet is not leveraged, and equity is 15x the level of long-term debt. It's certainly a sensibly arranged balance sheet.

There are many assets that have been owned by the company for a very long time, which probably have book values that are dramatically below the actual realizable private equity value. For example, the company owns an 826 kilometer pipeline network in Japan, an LNG tanker truck delivery network and a series of railway tanker cars for LNG delivery. The company also owns a number of exploration properties, some in Japan. There are some interesting development opportunities on the island of Hokkaido, and some in the northern Honshu island. It owns oil interest in Indonesia, oil sands properties in Canada, and there's the possibility of exploration in Iraq.

The company's oil reserves amount to 170 million barrels. Without taking into account the discounted present value of that oil, but only the current worth of the reserves, 170 million barrels of oil equivalent at \$40 a barrel is worth \$6.8 billion. The company's plans, whether realistic or not, are to double its reserves by 2013, in other words during the next five years. There is an emphasis on international deal making that, whether or not successful, is certainly not accounted for in the price of the stock.

Japan Petroleum is the sort of classical Graham & Dodd value that resides in Japan. It's one of the great ironies of history that 20 years ago, when the Nikkei Dow Jones was approaching 40,000, there was far more interest in investing in Japan than there is now with the Nikkei Dow approaching 7,000. It's not very difficult to find a stock at a 50% discount to book value in Japan, nor is it difficult to find a stock whose book value clearly understates the current market value of the assets. The Japanese equity market itself is interesting.

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APPENDIX A

Money Manager Index

From Jan 1983 to Feb 2009														Annualized return		
Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Yr. End	Index	Yearly return	(since inception)
1983								1.00	0.81	0.76	0.87	0.75	1983	0.75	(60.5)%	(60.2)%
1984	0.75	0.71	0.70	0.66	0.67	0.67	0.61	0.83	0.79	0.76	0.67	0.65	1984	0.65	(13.5)%	(26.5)%
1985	0.92	0.93	0.99	0.95	1.20	1.30	1.32	1.38	1.28	1.50	1.86	2.02	1985	2.02	211.8%	33.7%
1986	2.46	2.78	2.47	2.31	2.36	2.33	2.03	2.23	1.98	2.37	2.34	2.34	1986	2.34	15.9%	28.2%
1987	3.21	3.27	3.16	2.55	2.37	2.30	2.39	2.47	2.22	1.56	1.44	1.52	1987	1.52	(35.0)%	9.9%
1988	1.80	1.87	1.78	1.79	1.69	1.94	1.92	1.96	2.01	1.97	1.95	2.07	1988	2.07	36.0%	14.3%
1989	2.42	2.37	2.54	2.63	2.64	2.64	2.93	3.12	3.07	3.05	3.23	3.26	1989	3.26	57.8%	20.2%
1990	3.12	3.15	3.53	3.06	3.47	3.45	3.30	2.70	2.68	2.40	2.52	3.02	1990	3.02	(7.3)%	16.1%
1991	3.08	3.49	3.70	3.68	3.71	3.61	3.86	4.05	4.07	4.69	4.47	5.72	1991	5.72	89.4%	23.0%
1992	5.76	5.61	5.30	5.12	4.98	4.99	5.93	6.06	6.19	6.56	7.25	7.36	1992	7.36	28.6%	23.6%
1993	8.06	8.04	8.20	7.94	8.15	8.57	9.05	10.00	9.99	9.31	8.97	8.90	1993	8.90	21.0%	23.4%
1994	9.52	8.73	8.05	7.85	7.81	7.53	7.66	8.31	8.15	8.52	7.88	7.95	1994	7.95	(10.6)%	19.9%
1995	7.74	8.38	8.72	8.77	9.20	9.35	9.93	10.78	11.22	10.53	10.89	10.40	1995	10.40	30.8%	20.8%
1996	11.12	11.50	11.33	11.62	11.86	12.53	11.91	12.36	13.32	14.03	14.42	15.02	1996	15.02	44.4%	22.4%
1997	16.04	16.81	15.32	17.27	18.42	20.29	22.28	21.39	25.31	24.95	24.95	25.50	1997	25.50	69.8%	25.2%
1998	25.67	29.00	29.89	30.60	28.90	30.44	27.67	21.33	21.74	25.16	27.27	25.41	1998	25.41	(0.4)%	23.3%
1999	26.00	23.71	23.92	26.77	28.94	29.74	28.78	26.74	25.89	27.73	28.54	30.55	1999	30.55	20.2%	23.2%
2000	31.07	31.19	36.01	35.60	35.20	40.32	43.58	45.75	45.62	48.69	44.05	49.84	2000	49.84	63.1%	25.2%
2001	50.23	46.41	44.27	46.96	48.90	49.98	50.67	49.70	46.47	44.81	48.04	51.91	2001	51.91	4.2%	23.9%
2002	53.62	53.74	55.11	52.52	52.83	50.48	42.58	44.92	41.54	42.66	45.78	43.17	2002	43.17	(16.8)%	21.4%
2003	42.72	41.18	42.36	45.98	49.02	50.71	53.47	53.97	53.46	56.12	55.83	58.49	2003	58.49	35.5%	22.1%
2004	64.38	65.08	64.63	61.68	60.86	62.30	58.71	64.08	65.73	68.86	73.53	78.16	2004	78.16	33.6%	22.6%
2005	76.46	77.94	74.06	72.83	77.02	80.25	83.59	83.07	86.03	89.19	96.58	97.35	2005	97.35	24.6%	22.7%
2006	107.62	111.44	110.75	111.88	101.89	100.61	100.62	104.98	114.61	116.64	113.78	118.05	2006	118.05	21.3%	22.6%
2007	125.73	123.77	122.62	127.58	133.57	134.68	126.61	124.07	133.57	148.09	135.13	135.56	2007	135.56	14.8%	22.3%
2008	127.53	115.76	115.94	121.58	130.51	115.68	119.94	120.55	109.69	72.70	62.95	67.91	2008	67.91	(49.9)%	18.1%
2009	57.51	51.76											2009	51.76	(23.8)%	16.7%

Name	Amount Invested	Name	Amount Invested
Affiliated Manager	\$ 22,947	Pzena Investment Mgt	\$ 122,426
Alliance	\$ 7,633		
BlackRock	\$ 23,205		
Waddell & Reed	\$ 27,513		
Eaton Vance	\$ 2,641		
T. Rowe Price	\$ 2,423		
Franklin resources	\$ 908		
Legg Mason	\$ 1,000		
Federated Inv	\$ 26,381		

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APPENDIX B

International Money Manager Index

From Jan 1983 to Feb 2009													Annualized return			
Year	31-Jan	28-Feb	31-Mar	30-Apr	31-May	30-Jun	31-Jul	31-Aug	30-Sep	31-Oct	30-Nov	31-Dec	Yr. End	Index	Yearly return	(since inception)
1986											1.00	1.02	1986	1.02	10.0%	10.0%
1987	1.25	1.37	1.48	1.48	1.37	1.33	1.39	1.40	1.33	0.81	0.76	0.73	1987	0.73	(27.7)%	(23.3)%
1988	0.75	0.92	1.02	0.95	0.80	0.89	0.88	0.82	0.86	0.88	0.89	0.93	1988	0.93	26.4%	(3.4)%
1989	1.03	1.02	1.06	1.17	1.19	1.18	1.25	1.16	1.17	1.20	1.21	1.28	1989	1.28	37.8%	8.1%
1990	1.24	1.24	1.18	1.19	1.22	1.24	1.26	1.26	1.23	1.24	1.25	1.33	1990	1.33	3.7%	7.0%
1991	1.34	1.52	1.56	1.58	1.57	1.47	1.52	1.64	1.81	1.89	1.94	1.92	1991	1.92	44.8%	13.5%
1992	2.01	1.93	1.88	2.14	2.19	2.13	2.08	1.99	1.95	1.77	1.76	1.96	1992	1.96	1.9%	11.5%
1993	1.98	2.03	2.20	2.39	2.42	2.45	2.54	3.05	3.01	3.07	3.01	3.30	1993	3.30	68.7%	18.1%
1994	3.72	3.39	3.17	3.04	2.99	2.89	3.01	3.14	3.13	3.19	3.15	3.15	1994	3.15	(4.7)%	15.1%
1995	3.07	3.12	3.28	3.41	3.56	3.59	3.87	3.76	3.76	3.77	3.70	3.73	1995	3.73	18.6%	15.4%
1996	3.76	3.85	3.70	3.79	3.96	3.90	3.75	3.96	4.16	4.47	4.90	4.86	1996	4.86	30.3%	16.8%
1997	5.11	5.37	4.99	4.96	5.43	5.94	6.57	6.32	7.45	7.24	6.80	7.19	1997	7.19	47.9%	19.3%
1998	7.12	8.05	8.78	9.25	8.95	8.74	8.91	6.67	6.08	7.01	7.51	7.71	1998	7.71	7.3%	18.3%
1999	7.99	8.21	8.68	9.07	8.71	8.61	8.63	8.43	8.47	8.79	9.80	10.79	1999	10.79	39.9%	19.8%
2000	11.23	12.27	13.95	13.50	13.73	15.39	15.85	16.82	17.07	16.31	14.43	16.76	2000	14.43	33.8%	20.7%
2001	17.42	15.88	13.46	15.14	15.84	15.15	14.21	13.61	10.77	11.43	13.90	14.12	2001	14.12	(2.2)%	19.1%
2002	14.74	13.78	15.09	15.11	16.38	14.14	12.92	12.10	11.23	11.06	11.33	10.50	2002	10.50	(25.6)%	15.7%
2003	10.18	9.52	9.69	10.62	12.17	13.04	13.98	15.38	16.67	17.88	18.16	18.07	2003	18.07	72.1%	18.4%
2004	20.00	22.41	29.98	35.46	26.68	30.80	25.37	25.20	23.67	23.34	27.56	31.48	2004	31.48	74.2%	20.9%
2005	32.19	32.57	31.88	27.79	27.36	29.05	30.38	31.49	33.39	32.24	32.95	37.18	2005	37.18	18.1%	20.8%
2006	41.01	40.97	43.69	46.45	42.39	41.58	40.60	43.32	43.55	43.70	44.58	49.38	2006	49.38	32.8%	21.3%
2007	50.95	51.18	53.59	56.09	58.16	56.37	53.90	48.65	50.96	57.03	48.21	45.75	2007	45.75	(7.3)%	19.8%
2008	38.71	39.71	38.59	40.18	39.25	35.10	34.59	33.33	26.09	18.72	14.50	15.79	2008	15.79	(65.5)%	13.3%
2009	14.62	13.24											2009	13.24	(16.1)%	12.3%

Name	Amount Invested	Name	Amount Invested	Name	Amount Invested
IGM FINANCIAL INC	\$1,000	HENDERSON GROUP PLC	\$14,447	BLUEBAY ASSET MANAGEMENT/UNI	\$37,469
F&C ASSET MANAGEMENT PLC	\$1,203	RAB CAPITAL PLC	\$24,603		
INVESCO PLC (PREVIOUSLY AMVESC.	\$1,357	AZIMUT HOLDING SPA	\$21,908		
SCHRODERS PLC	\$1,208	AUSTRALIAN WEALTH MANAGEMENT	\$27,789		
RATHBONE BROTHERS PLC	\$1,208	EVEREST FINANCIAL GROUP LIMITED	\$23,437		
ABERDEEN ASSET MGMT PLC	\$1,208	NEW STAR ASSET MANAGEMENT	\$27,700		
CI FINANCIAL INCOME FUND	\$2,585	CHARLEMAGNE CAPITAL LTD	\$36,848		
MAN GROUP PLC	\$2,862	PARTNERS GROUP-REG	\$36,848		
AGF MANAGEMENT LTD-CL B	\$3,343	INVISTA REAL ESTATE INV MNGT	\$36,589		
SPARX GROUP CO LTD	\$11,762	ASHMORE GROUP PLC.	\$36,688		