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FIRST QUARTER REPORT 2008

HIGHLIGHTS

- **Major risk facing investors today remains the credit crunch.**
- **Merrill Lynch seen as a proxy of health for the U.S. financial system.**
- **Decoupling in financial markets continues.**
- **Avenue portfolios adding value and positioning for further opportunity.**
- **Case Study**: **"Opportunity to be found" by Paul Gardner (Financial Post March 2008).**

Major risk facing investors today remains the credit crunch

The major issue facing us as investors remains the credit crunch. The problem started with excessive high-risk mortgage lending in the United States but now has directly impacted the financial health of most companies who both borrow and lend money.

At Avenue, we primarily invest in established profitable businesses. However, most of our companies borrow or lend money to some extent. For this reason it is difficult to side step a credit crunch completely. We see our job as minimizing the damage and making sure the companies we own will be the ones which will be able to make a strong recovery.

Merrill Lynch seen as a proxy of health for the U.S. financial system

As a way to illustrate the current financial crisis, look to the stock price of Merrill Lynch as a good proxy for the health of the United States' financial system. Most investors woke up to our current financial mess during last August's stock market melt down. However, Merrill Lynch's stock price was already in decline having peaked in January of 2007. From its high to recent low, Merrill was down 62%. What is important for an investor to recognize is that we are now 14 months into this correction. While there may still be more downside, we need to start thinking about what we want to own in the financial sector when we inevitably come out of this turbulent period.

As well, this credit shock has had a significant impact on global stock markets. From their 2007 highs to recent lows the London market fell 21%, Tokyo fell 36%, Hong Kong fell 35%, Shanghai (China) fell 46%, and Bombay (India) fell 31%. What is interesting is that the TSX index fell 18% from the July 2007 high to the recent January low. As of this quarter end March 31st, the TSX is only down 8% from the all time high in July 2007. This is explained by the heavy resource stock weighting in our Canadian stock market index. Currently, energy and mining make up 46% of the TSX index.

Decoupling in financial markets continues

The divergence between financial and resource stocks is now referred to in the financial press as 'decoupling'. What is being described is the anomaly that a North American and European housing and financial collapse are not impacting Asian demand growth for raw materials. While this is indeed the case today, we are watching for signs that Asia's economic weakness might simply be delayed.

There is a second type of decoupling, and this is one we have been waiting for, where corporate bond yields have increased relative to government bond yields. A core strategy of Avenue's bond and equity portfolios is to own corporate bonds when the current yield justifies the risk. The credit crunch has negatively impacted all companies who borrow.

Avenue portfolios adding value and awaiting further opportunity

We believe the move up in yields has now gone to an attractive level for us to increase our investment in conservatively managed Canadian companies.

We have been adding to our holdings of bank and real estate bonds. Avenue's bond portfolio is now 70% in corporate bonds.

Avenue's equity portfolio remains defensively positioned and awaiting opportunity with 19.7% invested in cash and bonds. 48% is invested in hard asset businesses like energy, mining and pipelines. Only 9% is invested in Canadian banks. We have just added a 2.1% position in Bank America, a US bank. As well, we have 5.3% invested in insurance and investment management.

In summary, it is very tempting to want to run and hide during markets like these. This would be appropriate behavior if we were to know ahead of time when the stock and corporate bond markets are going to put in a bottom. Without this information, we will continue to own well managed businesses that are making money and we will move into new investments when profitable opportunities are presented. Again, we would like to emphasize to you the need to always be building the portfolio for where we believe companies will be making money a year from now.