

FIRST QUARTER REPORT 2009

HIGHLIGHTS

- **The Great Recession Identified.**
- **The “Fix” Focused on Financials.**
- **Recovery Time Frame is Still Unclear.**
- **Avenue’s Strategy Remains Unaltered.**
- **Case Study: Why we sometimes invest in a company’s bonds instead of its common stock.**

The Great Recession Identified.

We have been writing about the same topic of systemic financial distress since September of 2007. Until recently we were just able to make educated guesses about the situation but now most of its issues are identified and there is even a name for it. The Great Recession is now understood by what the problems are, what caused them and the enormity of the scale.

The main problem is one of excess private debt. Most of this extreme debt resides in financial institutions. However, individual consumers bear equal responsibility for borrowing beyond their means. As well, the problem is truly global.

What caused this debt bubble? Credit was easily available at artificially low rates to entice the borrower. Why were the loans granted on such a grand scale? The loans can be blamed on a complete breakdown in risk control at the lending institutions. The lenders are a broad group made up of banks, pension plans and hedge funds.

The combined amount of the financial sector debt and the household debt is roughly estimated at over \$10 trillion dollars in North America alone. Both debts need to be reduced to restore financial stability. It is important to keep in mind this colossal sum of debt when one tries to add up all the different bailout packages and stimulus which the US government has already deployed.

The “Fix” Focused on Financials.

The US federal government’s financial fix is focused on the stability of the banking system and not economic recovery. In spite of the criticism, the multitude of plans seems to be working to keep the doors of the banks open. While a global financial system collapse is still possible, we see it now as a more remote probability.

Why do the banks need saving by the tax payer? Banks are very much like public utilities. The way we live in modern societies requires smooth-running banks just like uninterrupted water and sewage. Why do we keep banks in private hands? We don't want politicians determining who gets a loan and who doesn't.

Why is the US federal government so desperate to save non-bank companies like General Electric and General Motors? A bankruptcy would have a huge impact on the financial system through the bond market. In a normal world a restructuring could be digested by the market. However, today these companies' bonds are so widely held that a default would simply add gasoline to the financial bonfire.

Stock markets hate uncertainty. However with the broad North American equity index's having corrected over 50% from the highs, a great deal of the loss to the real economy has already been discounted in the share prices of common stocks. Therefore knowing what the problems are and the related scale is vital to giving stability to the markets at this current level of prices.

Recovery Time Frame is Still Unclear.

The full impact of the solutions and the subsequent timing of a global financial recovery still remain unclear. However, history has taught us to be mindful that the stock market usually recovers a full six months to a year before the economy turns around.

Taking all this into consideration, Avenue's forecast is that we as investors need to temper our economic growth expectation. We believe that private debt levels will come down, consumer spending will stay restrictive for the foreseeable future and the saving of income will become a new creed. The result will be that Government will have less revenue and more debt due to the counter cyclical stimulus.

Avenue's Strategy Remains Unaltered.

Avenue's investment strategy remains unaltered by these economic conditions. More importantly, if our companies can make money in this environment then this confirms that these are the one we want to own for the long term. Avenue continues to focus on businesses that are low cost producers that continue to generate cash at the bottom of the economic cycle. We do find that larger businesses are more stable than small ones and we prefer ones with low debt levels.

Avenue's equity portfolio remains 34% invested in corporate debt. This 1/3rd weight provides stability to the portfolio and enhanced income which will be continuously reinvested in our core equity holdings as we go through this bear market. In the first quarter we added to our holdings of Royal Bank, Manulife Financial and Sherritt International as well as adding new positions in Research In Motion, Westshore Terminal and Fort Chicago.

It is important to constantly remind ourselves that investing from a low base or low valuation lays the foundation so that we can truly compound our Equity portfolio going forward. Avenue has a very realistic goal of doubling our equity portfolio in 5-7 years while reducing risk where ever possible. This is the time to keep putting money to work by buying great businesses.

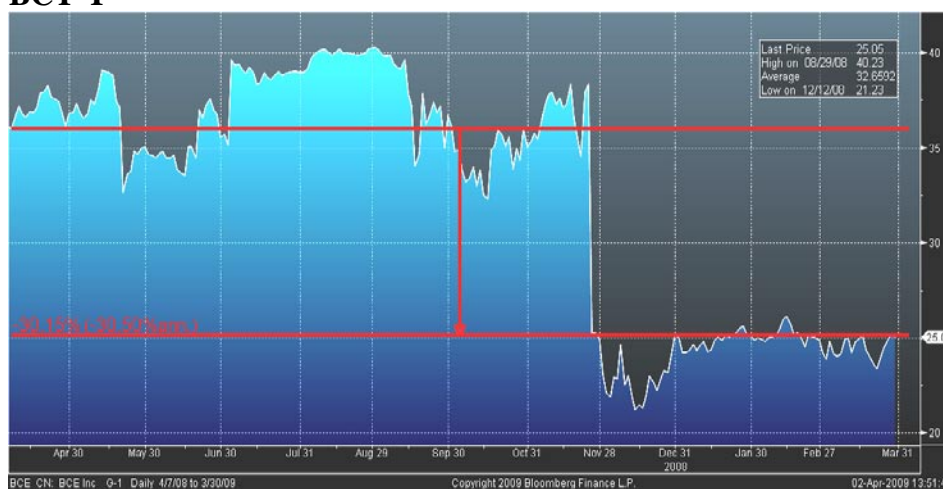
Case Study: Why we sometimes invest in a company's bonds instead of its common stock.

Over our five year history as a firm, we have discussed how we use corporate bonds in our equity portfolios to enhance our returns while lowering the volatility. We would like to illustrate this strategy by examining two investments we made in the past year and how they performed:

1. Buying Bell Bonds (Bell Canada 4.64% 2016) vs. Bell Stock (BCT-T)

In the fall of 2008, we decided that an 8% yield from these bonds was attractive. The yield was high due to the assumption that their balance sheet would be overleveraged due to the upcoming takeover by Ontario Teachers' Pension Plan. We also believed the "true value" of Bell shares was never worth more than \$25.00. By being a bondholder we never had to worry about the success of the takeover from Teachers', and if the takeover did fail we knew the bonds would rally. This was due to the understanding that the balance sheet would not be impaired and the bonds would be priced back to their pre-merger level. Our initial intention was to be content with an 8% yield and not "bet" on the outcome of the deal. As you know, the merger did fail and the bonds rallied while the stock dropped. At this point of writing, the stock was down 35% and the Bell Canada 4.64% 2016 gave us an 18% return (14% capital gain, 4% coupon) in 6 months' time.

BCT-T



Bell Canada 4.64% 2016

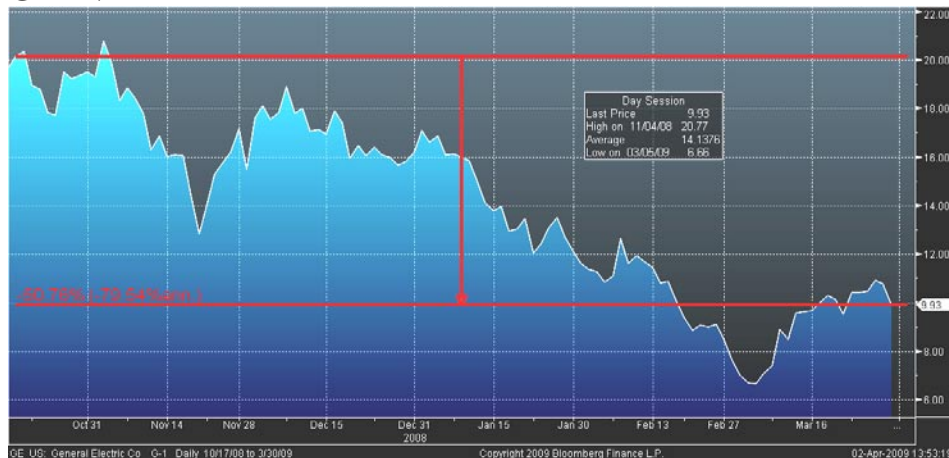


2. Buying GE Bonds (GECC 5.73% 2037) vs. GE stock (GE -N)

In October 2008, Warren Buffett gave General Electric \$3 billion dollars while receiving preferred stock that gave him a 10% yield and attached warrants. We wanted this deal but we do not have the opportunity or access that Buffett has. GE has a global reach, a solid balance sheet and was relatively cheap. After further consideration we decided not to buy GE stock and decided instead to purchase the GECC 5.73% 2037 bonds (the financial arm of GE). We did this for several reasons. First, it gave us an 8% yield with a possibility of earning more, since the bond was trading at a discount to maturity. Secondly, as bondholders or as a creditor of the company we stand higher up in the “pecking order” if GE goes into bankruptcy. Although we feel this will not happen, we do feel that under this volatile environment we are more comfortable owning the bonds and earning at least 8%, than buying the stock and “hoping” everything works out. Finally, in the unlikely scenario that GE does go into receivership, we would technically stand in the front of the creditor line before Buffett gets his money back. In essence, we stand in front of Warren Buffett as opposed to being behind him.

Since we invested, the bonds have lost 2% (-2% capital loss, 4% coupon) where the stock would have been down 51%.

GE -N



GECC 5.73% 2037

