



LAWRENCE PARTNERS FUND

September 30, 2005 Update

Performance Overview

NAV per share	Monthly Performance	Year-to-Date Performance	Since Inception Performance
\$102.59	+5.1%	+7.1%	+154.8%

Shares of Lawrence Partners Fund were up 5.1% in the month of September. This compares to 0.7% on the S&P500 and 3.2% on the TSX Composite Index.

During the month, we added three core positions to bring the total to 11 and we exited the month with 22 exposures including short-term trading positions. Though our total number of exposures varies from month to month, we continue to adhere to our limit of a maximum of 15 core positions including long, short, and hedged positions.

The positive performance during the month was largely alpha driven gains from our special situations long positions. The two largest exposures of the fund are hedged spread trades and had a combined negative contribution to the fund. The levels at which we exited September on these two key hedged positions of the fund are attractive.

The fund had virtually no exposure to energy in September. We had identified several structurally mis-valued securities in the oil & gas sector but made a technical call on oil prices that proved incorrect in September but is working our way in October. We have a lot of 'dry powder' to participate in this area and will likely be making two or three investments in this sector in October and November.

Market Update – Uncertainty for Income Trusts

The most significant development in September in our little market was the white paper and subsequent comments released by the ministry of finance regarding income trusts. These comments have resulted in confusion and turmoil. After the initial reaction which was broad-based and indiscriminate selling of all income trusts, the REITs and oil and gas trusts have recovered substantially, leaving the business trusts languishing in a limbo with no bids, no liquidity and an uncertain future.

Most of the commentary and prognostication on the Ministry of Finance's ultimate actions have been way off the mark. Our views differ significantly than those of the popular media.

It is clear that the government is troubled by the tidal wave of income trust IPOs and income trust conversions. Their concerns are based on the fear of tax 'leakage' and that the trust structure discourages capital expenditure, growth, and innovation. In fact, contrary to popular belief, the income structure causes none of the above.

Tax Leakage or Tax Creation?

Not all, but most of the companies now listed as business income trusts were previously private companies owned by a small group of shareholders. In some cases these shareholders were individuals, in other cases they were investment funds. In those cases where these companies were closely held by individuals, there was in all likelihood little or no corporate tax paid as any excess profit would have been paid out to shareholders in the form of bonuses or an equivalent in order to eliminate the company's taxable earnings – a net effect highly analogous to being an income trust. In those cases where these companies were owned by investment funds, they are almost always highly levered and carrying a heavy interest-expense burden and so again, paying very little tax at the corporate level. Moreover, the debt issued by these companies is often owned by non-taxable entities such as pension funds, so there is in some cases, almost no tax paid anywhere.

Now consider the effect of converting to an income trust. First of all, the conversion to an income trust structure is a deemed disposition and in most cases, a significant capital gain and a tax windfall for the government. Second, once in income trust format the company pays out a high yield to investors, most of whom are taxable and taxed at the highest marginal rate. Finally, the significant capital appreciation enjoyed by income trusts because of their desirable qualities comes with an embedded capital gain – another tax that must ultimately be paid.

It is quite impossible to calculate precisely how much tax revenue has been lost, gained, or deferred by the income trust phenomenon, but it is clear that the notion of tax leakage is not as cut and dried as most believe.

Stifling capital expenditure and growth?

It is true that the concept of 'distributable cash flow' and the multiple applied to it encourage income trust management teams to be very frugal in their capital expenditures. However, a majority of the best performing trusts have been those that have been able to deliver growth. In most cases, these trusts have chosen to re-invest significant percentages of their cash flow in their businesses, presumably because they believe there is a sufficient return on that investment to justify not delivering that cash on to unitholders. This is the same decision process that should be undertaken by the management teams of every company. However, most common share companies that have significant free cash flows retain a large percentage of it. Historically, this has inspired actions that ultimately destroyed shareholder value: acquisitions, diversification into other businesses, and tilting after windmills in a capital expenditure sense. Conversely, with the rigor and discipline enforced on income trust management teams who have to cut cheques to unitholders every month, these outcomes are all but impossible.

So what will be the ultimate outcome of the Ministry of Finance's deliberations? Impossible to say given that their motivation is not necessarily based on logic and what is best for Canadian capital markets in the long-term. However, we believe the following to be a likely set of events:

- i) Almost no change to the status of REITs or Oil & Gas Trusts. These structures predate 'business trusts' and were created for reasons that have not changed with the passage of time.
- ii) An elimination or boxing in of the so-called third generation trust structure – that of a trust-on-limited partnership versus the first generation trust-on-corporation structure. The third generation trust structure eliminates LCT and taxation caused by growth in the underlying business – two things we believe are very irritating to the tax man.

- iii) An elimination of the specter of foreign ownership restrictions on income trusts. Currently the rule is “trusts must be created primarily for the benefit of Canadians” which certainly implies that a majority of unitholders must be Canadian. However, this is not explicitly stated. We believe this will be removed, possibly with the addition of what effectively amounts to an additional withholding tax.
- iv) A tax on business trusts only, designed to encourage them to either distribute all of their cash flow which will be taxed in investors hands, or invest that money in growth capital expenditures. A foolish and difficult tax to implement but one that nonetheless seems possible at this point.

The fund has several positions, both long and short, in the income trust market. We have not as yet suffered material negative consequences from the Ministry of Finance commentary. However, we are following events carefully and will act accordingly. We believe there will be many opportunities for us to make money in this volatility and confusion.

Lawrence Partners Fund Featured Position

XS Cargo is a big-box discount retailer and one of the income trusts that the fund maintains a long position in. The company is best described in their own words, appropriated from their website:

There's nothing but bargains at XS Cargo. We bring you brand name products purchased from distressed situations at incredibly low prices. We are not a traditional retailer. We only buy products to sell at deep discounts from regular retail prices. Shopping at XS Cargo is a bargain hunting adventure.

CLOSE-OUTS - In a hyper-competitive wholesale and retail marketplace manufacturers and distributors are constantly changing their products, packaging and channels of distribution. Product cycles have never been shorter. This provides us great opportunities to buy end of line product close outs and pass the savings on to you!

XS INVENTORY - Manufacturers and retailers often find themselves with excess inventory resulting from cancelled orders, factory over runs, returns, buying errors, and other misfortunes. Our buyers offer solutions to these inventory problems at the deepest discounts possible.

BANKRUPTCY - We buy products from retailers, distributors and manufacturers going out of business - at a fraction of the original cost!

WAS SEEN ON TV - Even the best TV shows come to an end. It's no different for "As seen on TV" products. Our knowledgeable buyers identify product stars that have been pushed out of the limelight by younger models.

RETURNS - XS Cargo purchases famous brand name products that have been returned. Most major retailers send their customer returns back to the manufacturer, regardless of the reason for the return. These products are inspected, serviced as necessary and guaranteed to perform to full manufacturers specifications. Most products are returned in perfect working condition but are required by law to be classed as "Refurbished". It's your opportunity to save big on quality brand name products. For more information on "Refurbished" go to FAQ

CASH IS KING - No matter what the inventory problem, our solution is cash. XS Cargo buys merchandise with cash upfront securing the best deals for our customers.

HOW CAN WE DO IT FOR YOU?

Visit an XS Cargo outlet today for famous brand name merchandise at a fraction of the original cost!

We love the business for several reasons. First, they have significant growth opportunities. In fact they can triple the number of stores they operate before cannibalizing existing stores. Better yet, the capital expenditure required to open a new location is on the order of \$100,000 and they can easily finance their growth from cash-flows – there is no need for them to ever issue new equity. Moreover, the company has no long-term debt and utilizes its credit facilities only in ramping up their inventory going into Christmas. We believe the company has the ability to increase its distributions to shareholders significantly over the following 3 years. Our model suggests that the company will exit the coming years with the following distributable cash flow per unit (DCPU) run-rates:

	<u>2005E</u>	<u>2006E</u>	<u>2007E</u>	<u>2008E</u>
DCPU	\$1.44	\$1.62	\$1.84	\$2.05

This kind of growth warrants a growth multiple which the market does not yet afford the company.

Second, while the company is a retailer and exposed to consumer spending, the nature of the business is far more defensive in a weaker retail market. Finally, the management team is excellent and owns 50% of the shares outstanding.

XSCargo is a classic example of the difficulty the income trust market has at pricing growth-oriented companies. Historically high-growth businesses have been undervalued as trusts and in some rare instances, trade at valuations lower than they would as common share companies. We believe that XS Cargo shares will continue to trade in the \$12.50 - \$13.50 range until they increase their indicated distribution. As XSCargo's ability to grow and increase distributable cash-flow becomes more apparent, the market will begin to afford XSCargo a growth multiple similar to that enjoyed by Sleep Country Canada which is a better known brand but has inferior growth prospects over the next 2 years.

Looking Ahead ...

As always, we are focused on our list of core investments and very selectively adding new positions. We currently hold a net cash position and have capacity for new investments.

The income trust and broader markets are likely to continue to exhibit significant volatility in the near term. For us this creates short term trading opportunities and entry points on potential long-term investments. Energy and energy services companies are likely to present very interesting values in the near future and are currently occupying a significant percentage of our time and efforts.

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