

The Donville Kent Financial Service Venture Fund seeks to provide long term capital appreciation by investing in the stocks of companies in the Canadian financial services industry. The Fund's overriding theme is to look for emerging growth companies within the Canadian financial services industry that are capable of generating returns on equity (ROE) well in excess of the firm's cost of equity for many years to come. The companies the Fund invests in are typically led by strong management teams, conservatively financed and they enjoy an advantageous competitive position within their respective industry segment.

Why invest in Canadian Financial Services stocks?

A few years ago a friend of mine attended the Wesco Financial Corporation's annual general meeting (AGM). Investors who are not familiar with this company should note that Wesco is the holding company through which Charlie Munger, Warren Buffet's intellectual and investment sidekick makes most of his investments. As a generalization it is safe to say that Wesco is to Munger what Berkshire Hathaway is to Warren Buffett. In any event, my friend (a Toronto based portfolio manager) decided to attend the Wesco AGM because 1) the Berkshire Hathaway AGM had become a "gong show" with attendees numbering in excess of ten thousand and 2) my friend felt that Munger's insights were likely as valuable as Buffett's.

Sure enough, he was not disappointed with his decision as only a small fraction of the crowd that attended the Berkshire AGM attended the Wesco AGM and as importantly he was actually able to pose a question to Munger. The question was "after a lifetime of investing alongside Buffett, did either he or Buffett have any great regrets?"

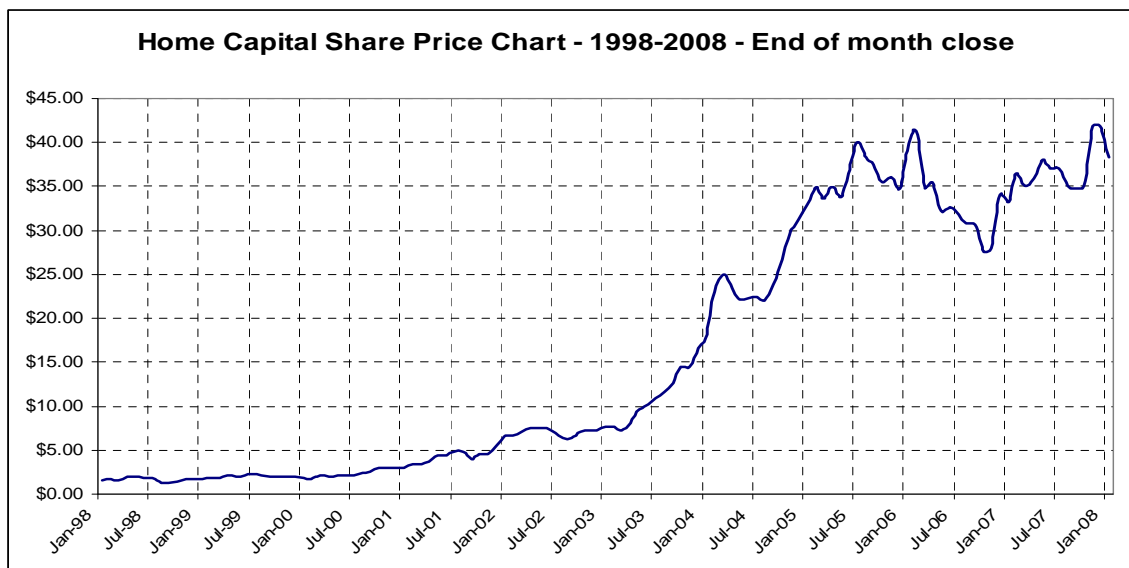
Munger replied that he and Buffett had few regrets over their years of investing. However perhaps the one regret was that they wished they had owned an even higher proportion of financial services companies within their respective investment companies. This is ironic given the already high weighting of financial services stocks within the investment portfolios of both Wesco and Berkshire. Evidently, both Buffett and Munger felt they had underestimated the ability of so many small to medium sized financial services stocks to put up high, compounding returns over several decades. Many of these stocks could have been bought or acquired at a reasonable price, and today many are now valued in the billions of dollars.

Mungers comments and ideas are also the central premise of the DKAM Financial Services Fund. Over the past fifteen years I have had the privilege of analyzing and documenting the performance of some of the finest financial services companies in both Canada and Asia and it has led me to invest a substantial amount of my net worth in the financial services industry. In both Asia (where I worked from 1992 until 1999) and Canada, I have had the opportunity to follow a large number of small to medium sized financial services companies that have subsequently created vast amounts of wealth for their investors. It is thus the goal of the

DKAM fund to invest in those companies that I believe are capable of generating similar levels of wealth for a new generation of investors.

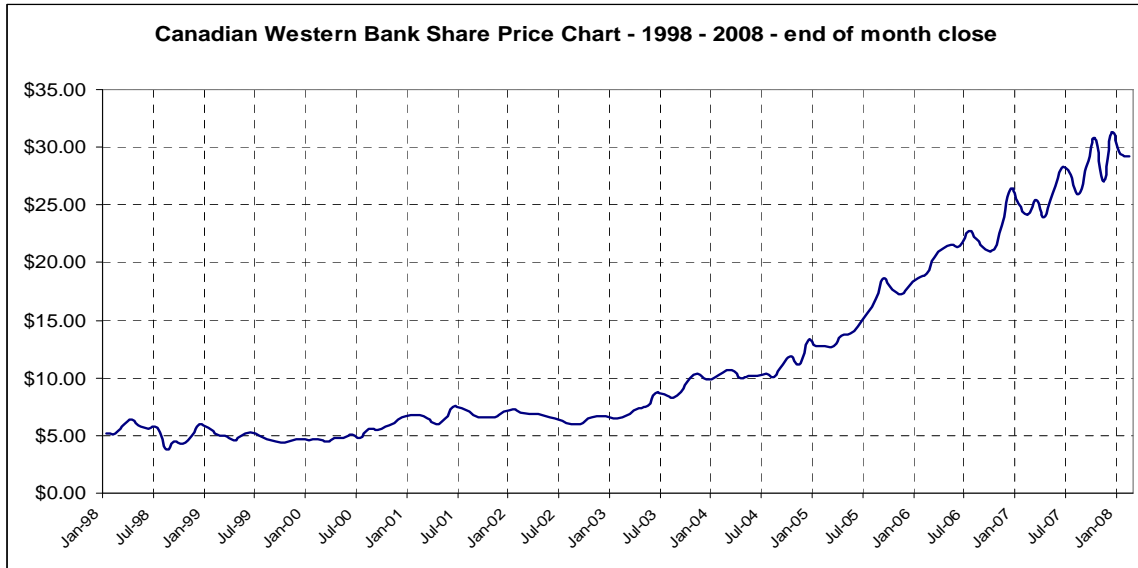
Examples of Great Wealth Creating Companies in Canada

When I look for a great company, I start by screening for return on equity (ROE) that is substantially higher than a company's cost of equity. In 2001 I came across a small, federally regulated deposit taking trust company which was only modestly levered and featured an ROE in excess of 20%. It was run by one of the most capable CEO's I had ever met (Gerry Soloway) yet the company had virtually no following in the investment research community. At the time that I initiated coverage, the stock was trading at something close to 8x current year earnings and growing at more than 20% per annum. Shortly after I initiated coverage on the stock I took the CEO to Montreal to meet with institutional fund managers and, notwithstanding its reasonable valuation, I distinctly recall struggling to fill a day of company visits with fund managers. However, a few astute investors did take the meeting and began to buy shares in Home Capital and those early believers were extremely well rewarded. Since the time that I first met Soloway, Home Capital's stock has risen dramatically and the company remains as well managed today as it was when I first encountered it. It is also worth noting that the share price chart below covers a ten year period starting in 1998, whereas I only discovered the Company in 2001 – my point is that Home Capital was already a terrific company long before I came across it and I expect it will continue to be a fantastic wealth creating machine for many years to come. Great companies like Home Capital are not "flashes in the pan" and we can experience significant upside as owners if we can buy stakes in such companies ahead of the crowd.

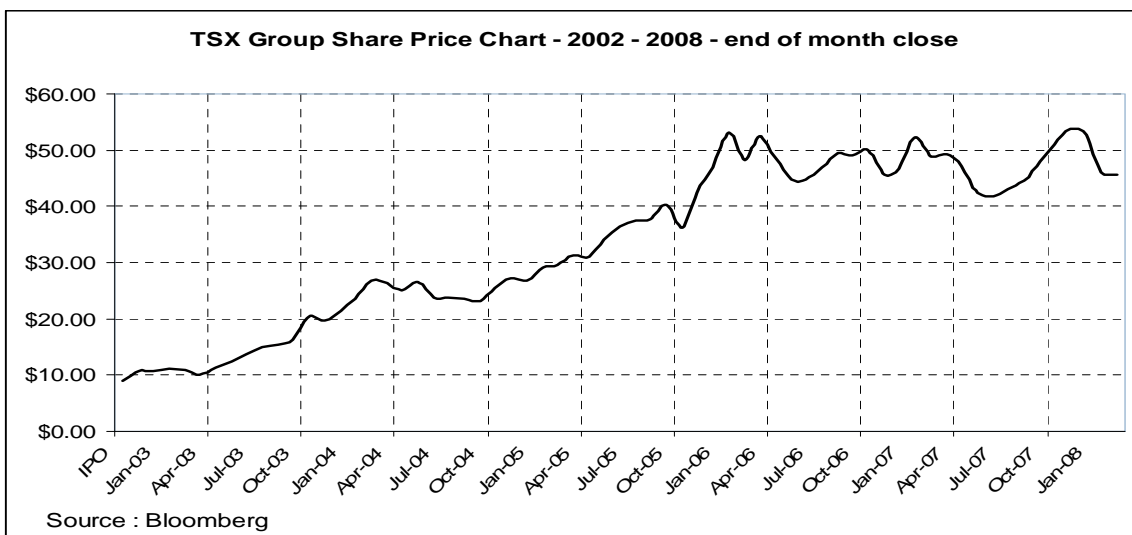


Around the same time period (2001) I also commenced research coverage on a small Edmonton based lender, Canadian Western Bank (CWB). At that time, CWB was much like Home Capital in that it was receiving scant coverage from the Toronto based analyst community even though it possessed a solid ROE, a single digit P/E ratio, a conservative balance sheet and an absolutely first-class management team (Larry Pollock, Tracey Ball and Bill Addington). The stock was also trading at 1.1x its current year book value per share and thus its valuation was unbelievably low. At that time, CWB was focusing on the mid-tier commercial lending market in western Canada while the Toronto based banks were hardly

anywhere to be seen. Thus while no formal oligopoly existed, CWB faced limited competition in its own back yard. Like Home Capital, CWB was already performing well when I came across the stock and since then it has been among the best performing stocks in Canada.



The two preceding companies I have mentioned are lenders (one a trust company and the other a regional bank), while the third Company I will discuss is the TSX Group. The Toronto Stock Exchange has been around for more than 100 years but it is relatively young as a public company. Indeed, at the time of its 2002 IPO, many investors felt the stock should be avoided for a variety of factors ranging from the gloomy prospects of the global economy to the fact that its selling shareholders (essentially brokers) were too smart to sell anything that had any real value. As the first analyst to initiate coverage on the company, I saw a stock with a huge amount of upside due to a lack of competition and significant opportunities for operational efficiency. Since its IPO, the stock has been a huge “Win”, having increased roughly five fold along with a significant rise in its dividend. As exciting as this return might seem, its IPO in late 2002 was barely 1 times subscribed with only 2 or 3 Canadian institutions buying the stock in any size. Going forward, the TSX will face some challenges from the launch of new trading platforms but its competitive advantage in market data, listing fees and energy trading are largely intact.



Why does the financial services industry produce so many winners?

The preceding discussions on Home Capital, Canadian Western Bank and the TSX Group are meant to provide investors with a flavour for the kinds of companies that exist in the Canadian financial services industry and that DKAM intends to focus on. These are only three companies, but there have been more; GMP Capital, Northbridge Financial, Gluskin Sheff, EGI Financial, Grey Horse Capital, Canaccord Capital, Solium Capital and Sceptre Investment Counsel are additional examples of financial services companies that have dramatically outperformed both the market and the large cap financial services sector over the past five years. Indeed the small to mid-cap financial services segment tends to produce a disproportionately large number of these kinds of stocks, and I believe there are four key reasons why this is so.

- **Reason # 1 - Oligopoly** – An oligopoly is a market or industry that is dominated by a few sellers. These industries tend to have high barriers to entry and a high degree of interdependence between competing firms. Companies that operate within oligopolies tend to enjoy super-normal profits over long periods of time and in our view the Canadian financial services industry has many sub-segments that enjoy oligopolistic conditions and therefore enjoy super-normal profits. It is worth noting that oligopolies are generally illegal and in Canada we doubt that few if any financial services companies formally collude. That said, for an oligopoly to function its participants need only be aware of the actions of the others and they do not necessarily need to be in direct contact with each other. In Canada, we view the banking, custodial banking, stock exchange, life insurance, property and casualty, and investment banking industries as all having significant oligopolistic attributes. This point can be substantiated from many different perspectives but one simple examples illustrate this point unequivocally. In an environment of perfect competition, a company should earn a return on capital that is equal to its cost of capital. In 2007, of the 28 stocks within the TSX Capped Financial Services Index, 27 (96.4%) earned a return on capital greater than the company's cost of capital, with 20 of the 28 (71.4%) earning a return on their capital that was at least 1.5x higher than its cost of capital. In the context of industry returns, those are outstanding numbers which suggest "super-normal" profits are indeed occurring throughout the Canadian financial services industry.
- **Reason # 2 – A high degree of industry oversight** – Closely related to the oligopoly issue is the fact that the Canadian financial services industry tends to operate with a high degree of regulatory oversight. While many investors have general disdain for oversight in their own lives (the proverbial big brother watching you), the overall effect of this regulation for is positive for investors for two reasons. First, regulatory hurdles present huge barriers to entry into the financial services industry which further reinforce the oligopolistic conditions that drive super-normal profits. This means that incumbents face few threats from new rivals. Second, the regulators in this country are obsessed about preventing a financial institution (FI) from failing, and thus they tend to hold most Canadian FI's to fairly tight operating standards. What does this mean? Most regulated FI's in Canada must report on a monthly basis to their regulator, with details of their activities, problems and issues. These same regulators ensure that these FI's operate within certain boundaries in terms of leverage, concentration, risk weighting, etc. Thus, the regulator represents a highly skilled entity that is on the inside and continuously monitoring these FI's for problems. In my view the actions of the regulator also serves the best interests of the shareholders as well. Thus, there is arguably no other industry in Canada that I am aware of where investors have a guardian angel watching out for their investments the way the regulators do in the financial services industry.

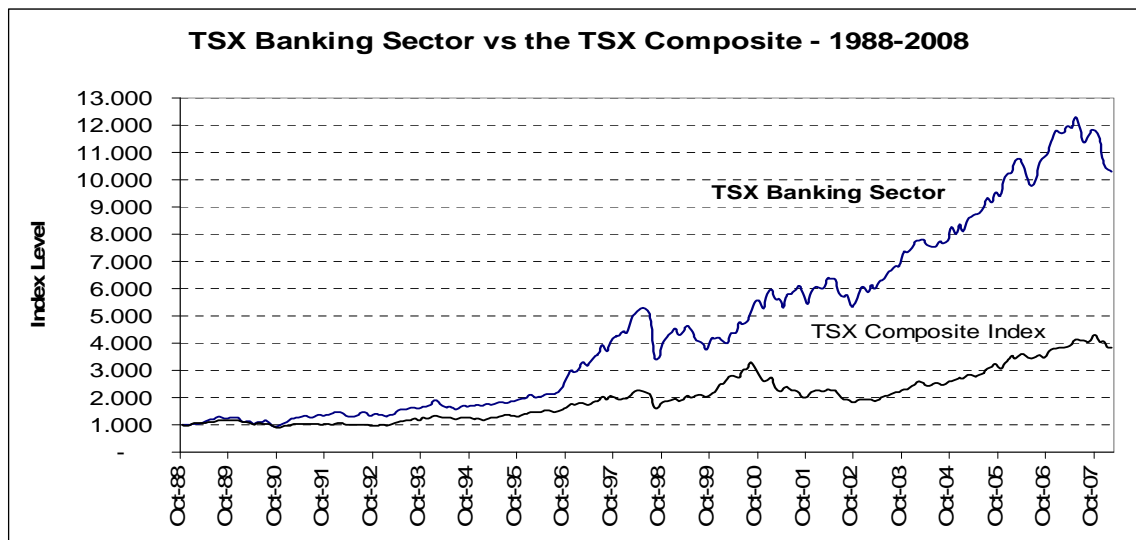
- **Reason # 3 – High quality management teams** – For reasons not abundantly clear, the Canadian financial services industry tends to attract strong managers to relatively early stage companies. This is perhaps related to the issues of industry oversight although one could argue that the absence of competition and/or the guiding hand of the regulator make the entire management teams look like geniuses. Regardless, I am often quite surprised when I meet management teams outside of the financial services industry to discover how unsophisticated they are relative to financial services management teams of a similar size and market capitalization. That said, these management teams should not be viewed as staid – some of the finest entrepreneurs in Canada are founders of, and own large stakes in the best financial services companies in Canada.
- **Reason # 4 - The existence of consumer monopolies** – Canadians tend to be extremely loyal to their banks and insurance companies, and one could argue that most of our largest FI's are in fact consumer monopolies. "Consumer monopolies" tend to build up an immediate loyalty with their consumers and this allows the company to spend very little time or resources on retaining the client. Consumer monopolies often exist as part of an oligopolistic industry and tend to enjoy large barriers to entry, name brand loyalty, terrific excess cash flow and modest capital expenditure needs. A newspaper is a case in point. Once you find a newspaper that you enjoy reading, you become reasonably price insensitive and there are no true substitutes. Retail coffee is similar – whether you like Starbucks or Tim Hortons, chances are you are fiercely loyal to your brand – and that's what makes this a consumer monopoly – and makes these companies incredibly profitable. Many financial services companies tend to develop the same loyalty from their customers. The financial services industry tends to produce a disproportionately large number of these and key examples that Warren Buffett has invested in include American Express (does anyone buy any other kind of travelers cheque), Wells Fargo, GEICO and M&T Bank.

In summary, if you want to hunt for big game (stocks that create massive value) it helps to hunt in the best stocked game park you can find. In the context of the Canadian capital markets, I am unaware of any other segment that offers the depth and breadth of quality that the Canadian financial services industry does. Two questions remain; "when should you Buy?" and "what should you?"

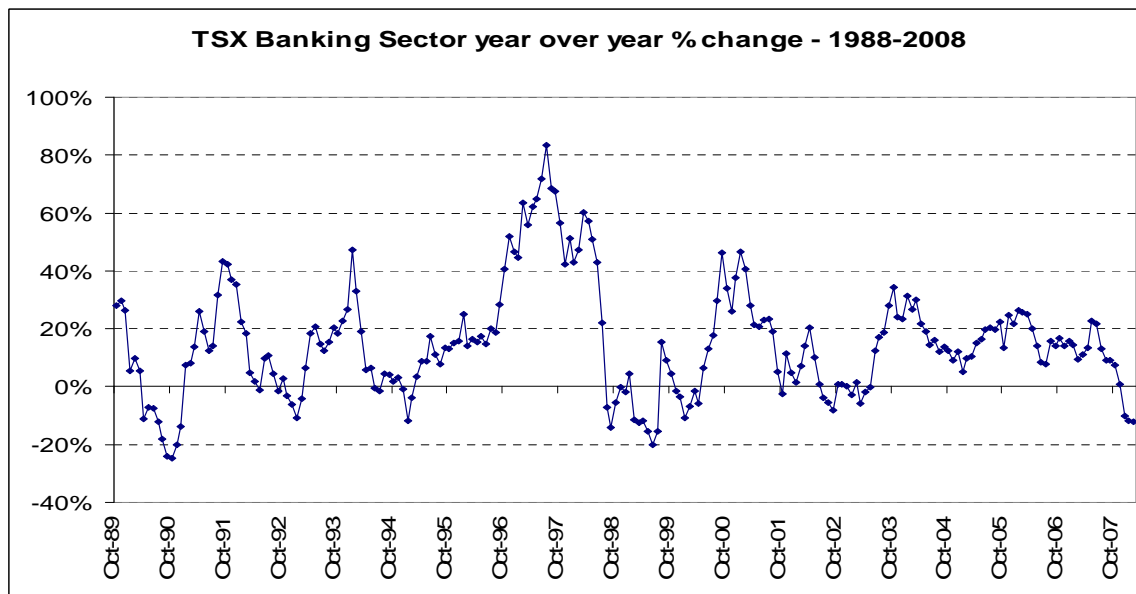
Is now the time to invest in Canadian Financial Services stocks?

Although I have lots of positive things to say about the Canadian financial services industry, the question often is "Is now the time to invest?" In my view, it is always a good time for Canadian investors to buy financial services stocks but given the markets current state I accept that some investors will need reassurance.

The long run case for investing in the financial services industry is fairly straight forward and the figures below illustrates this point. It shows that over the past twenty years, the TSX Banking sector (a proxy for the financial services industry) has outperformed the TSX Composite Index by a factor of roughly 2.5:1. However, what this figure does not show would make these results even more emphatic. Roughly 1/3rd of the TSX Composite's value is composed of financial services companies. If we net out the positive impact of the financials on the market index, we see that the financials relative performance is even stronger. Second, financial services stocks tend to be big payers of dividends, whereas both indices below exclude the impact of dividends. The inclusion of dividends would once again exaggerate the performance of the financials over the broader market. Thus, the super-normal profits in the financial services sector we have previously discussed have clearly translated into super-normal stock returns for Canadian investors over the past twenty years.



Is now a good time to buy financials? Below we present a figure that shows the year over year return of the TSX Banking index going back to 1988 on a monthly basis. This figure shows that the TSX Banking index periodically sells-off, which was in fact the case in 1990, 1998 and 2002 and which is now occurring once again in 2007/2008. From this chart we can make a couple of key points. First, virtually every major sell-off has led to a large bounce back in the market in a relatively short period of time. Second, the positive bounce that normally follows is large. Indeed, the best performance years for the stock market typically occur immediately after a major sell-off, regardless of whether or not it was caused by economic factors (as was the case in 1990 and 2002), or other factors (the boom bust of 1995 through 1998 was caused by the on again/off again issue of bank mergers).



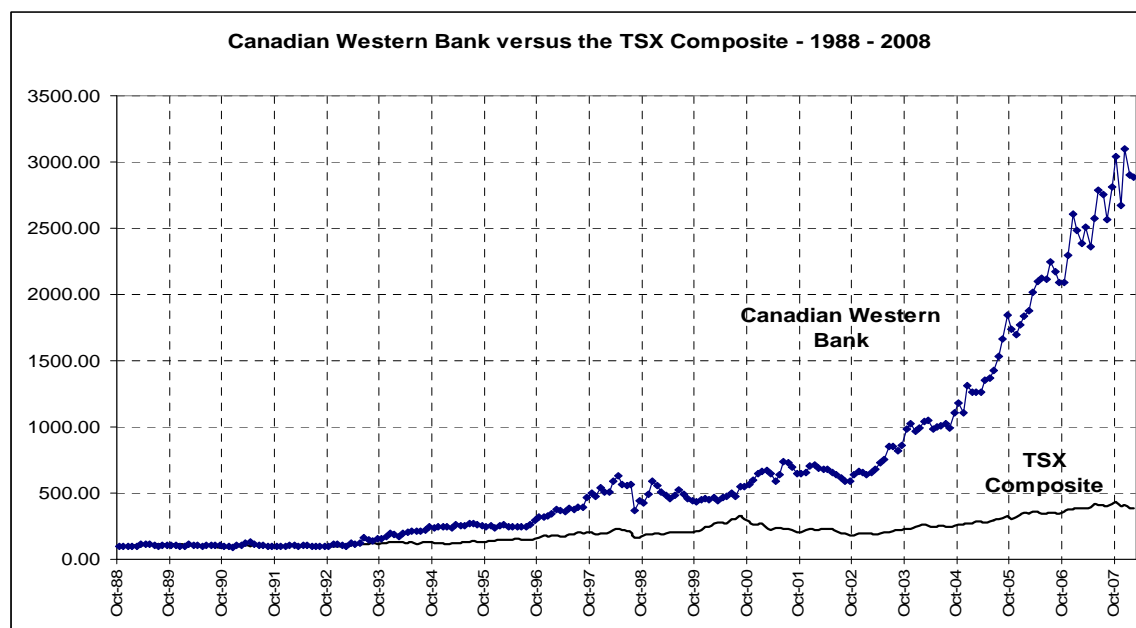
Does this mean that the market is ready to rebound today? Based on past cycles, the risks faced by investing in financial services stocks now are modest because a relatively large correction has already occurred, and this point can be illustrated by referring back to the figure above. Note that once stocks fall below the 0% line, they tend to only stay below that line for a relatively short period. The other timing issue with respect to the financials that is worth noting is that when the overall

market does begin to recover, in past cycles this rebound is typically led by stocks in the financial services industry. For example, in the 1990 to 1992 recession (which for the financials was the most severe of the past 25 years), the sector actually bottomed in October of 1990 while the recession carried on for more than a year. From that bottom, the financials bounced on average 40% in the subsequent 12 months. This is typical of virtually all sell-offs in the financial services industry and a consistent phenomena when the sell-off is driven by economic factors.

So why do the financials lead the recovery? First, the risk premium begins to diminish as investors slowly begin to realize that these FI's are not going to fail. Another way of looking at this is in terms of P/E multiple expansion. As the risk perception of the sector improves the multiples on these stocks begins to expand rapidly and indeed most of the stocks performance at this stage in the cycle can be attributed to an expansion in the earnings multiple rather than a rebound in earnings. The second factor that explains why financials typically lead the recovery in the market is that an economic recovery typically occurs in tandem with the lending of money (banks) or the raising of capital (investment banks, bourses, brokerages) and thus the financials are among the first parts of the economy that re-embrace the growth of the economy. Thus, while I can't forecast exactly when the financials will start to rise again, I am highly confident that when the TSX as a whole begins to rise, it will be led by the financial services industry.

Why invest in the DKAM Financial Services Venture Fund LP?

The financial services sector is a fantastic place to invest. However, the “Holy Grail” of the DKAM Fund is to invest in high ROE stocks that have yet to appear on investor’s radar screens. Canadian Western Bank is one of the best examples. This Company has been around since the mid 1980’s but was virtually unknown in Canadian capital markets until 2-3 years ago when the crowd discovered it. Our goal is to find those outstanding companies early and build substantial positions before it gets on everyone else’s radar screen. The kinds of stocks that I am looking for have high ROE’s, conservative balance sheets and strong management teams and are companies that can sustain this kind of performance over many years can create significant amounts of shareholder wealth. The long-term chart of CWB versus the TSX illustrates this point.



About the DKAM Financial Services Venture Fund LP

The DKAM Financial Services Fund launched in January 2008 and ended its first month in the black. Currently, the fund is 80% in cash, and holds small positions in 9 companies. The Fund intends to be fully invested by Q3/08 at the latest and will be closed to new investors once the fund hits the \$25MM level. If you enjoyed receiving this newsletter and/or would like to learn more about the fund, please contact Jason Donville at 416-364-8886.

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