TETREM
QUARTERLY REVIEW

MARKET REVIEW

Over the past couple of years we have written about the high level of investor complacency present in global financial markets. The complacency has not been limited to North American equity markets, but has been a global phenomenon across multiple asset classes including commodities, real estate and fixed income. It was perhaps best represented by the very tight credit spreads investors were willing to accept as they stretched for yield to wring out marginally higher returns. That complacency was shaken in the third quarter of 2007 as the U.S. sub-prime mortgage mess spread into the broader debt markets and investors re-priced risk across multiple asset classes and countries.

The resulting anxiety triggered a broad-based equity correction during the summer. From their mid-July peaks to their August 16th lows, the S&P 500 Index and the S&P/TSX Composite Index fell 11.7% and 14.8%, respectively. The anxiety was short-lived as these equity markets turned around quickly and rallied to new highs in the early days of October (as this commentary was written). Why did investor sentiment swing from bearish to bullish so abruptly? The simple and best answer is that on September 18, the U.S. Federal Reserve blinked and gave the market what it was begging for by lowering the all-important Federal Funds rate by 0.5%. To understand why the Fed became dovish on interest rates we have to go back to the market crisis itself.

To a large degree the market sell-off was triggered by a loss of confidence in the quality of underlying collateral for various types of debt instruments as opposed to true economic weakness. That is one of the reasons we remained bullish throughout the crisis. As long as the crisis remained contained to the housing sector, the knock-on effects would be limited. The sub-prime crisis is negative for consumer spending but the global economy is no longer dependant on over-extended U.S. consumers who have lost the tailwind of rising house prices. Additionally, we saw the following bullish characteristics in both Canada and the United States despite the crisis: job creation, strong corporate balance sheets, and most importantly, cheap stock valuations. Overall, we viewed the correction as a healthy wash-out that helped rebuild the proverbial "wall of worry" that is required for stocks to climb.

For a central banker, the silver lining of a slowdown in housing prices is that it acts as a deflationary shock to the economy and reduces Inflationary pressures. For most of the year, the U.S. Federal Reserve was concerned that inflation posed a threat to the economy. As long as it held that view, it couldn't lower interest rates. Many financial market participants were begging the Fed for an interest rate cut as the sub-prime mortgage crisis spread into the broader debt markets. Those markets had seized up as lenders had grown wary of counterparty risk. However, Chairman Ben Bernanke had to avoid the moral hazard of appearing to bail out speculators, many of whom were complicit in creating the sub-prime problems in the first place. In the end, pressure to save the housing market and possibly the economy was too great. The weakness in the housing market, which had so many fearing a recession, provided cover for the Fed to lower the all-important Federal Funds Rate. This helped clear the constipation in the credit markets and provided a turbo boost to the equity rally that was underway prior to the cut.

Momentum Market

Our main concern today is that the argument for the Fed to stand pat was a good one. Anticipation of the rate cut lifted stocks out of their doldrums with leadership coming from the same momentum stocks that had surged earlier in the year. Momentum stocks are favoured by speculators who have very little respect for fundamentals or historical valuation levels. Mr. Bernanke's decision to lower interest rates provided a green light for speculators to lay more money down and to continue to run-up the share prices of their favourite momentum stocks. We are witnessing a sequel to the late-1990s' technology-media-telecom bubble, though admittedly to a far lesser extent. This time around the momentum players are somewhat more discerning: valuations are not as high and the targets are not limited just to technology companies.

Research In Motion is an example of a momentum stock that has rallied to new highs since interest rates were lowered. We have no argument with the quality of its products and the historical growth of the company, but with a quarter-end valuation of 78 times earnings and 16 times sales, it does not come close to meeting our disciplined criteria for ownership.

Our concerns around the current valuation levels of momentum stocks are not limited to what we do not own. The momentum investment cycle has quite often provided us with opportunities to realize substantial gains. For example, in our U.S. equity portfolios we have owned Apple Inc. (formerly Apple Computer) since 2002, and it has become a favourite of investor-speculators. The difference is that Apple's valuation is at a steep discount to Research In Motion and we believe that Apple's fundamental position is better. However, we have been selling down our positions in the company and will have likely exited our holdings entirely by the time that you read this. No matter how good a company we think Apple is, or how rosy its prospects, its share price tells us it is time for us to move on and find better investment opportunities elsewhere.

As value investors, that is what we do. We buy shares of out-of-favour companies when they are trading at a discount to intrinsic value and therefore offer a greater of margin of safety. If we are fortunate to own the ones that perform extremely well, we sell them as they become over-valued. That is what we are doing with Apple today. It is our discipline.

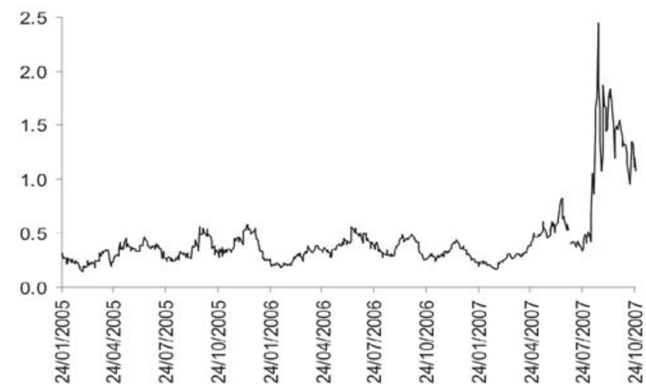
It is as difficult today as it was in the late 1990s to say when the momentum fixation of this market will run out. Momentum markets require new marginal buyers to keep the momentum going. It is the price strength and the hockey-stick stock charts that suck them in. Sooner or later the momentum ends and the most obvious trigger point is a loss of momentum in earnings power. When that happens, investors realize that there is very little fundamental valuation support for the share price and a violent sell-off occurs. We don't like to be around at times like that.

Investors should be concerned over declining earnings estimates for the S&P/TSX Composite Index and the S&P 500 as we enter the fourth quarter. However, the run-up in equity prices indicates that investor complacency has returned. At the end of June, 2007 bottom-up expectations for S&P 500 corporate earnings were running at 6% year over year. By early October these same estimates had declined to the point when they were negative. If actual earnings are in line with estimates it will be the first year-over-year decline in S&P 500 quarterly earnings since the second quarter of 2002. As we progress through this quarter's earnings season, the risk is that estimates for the fourth quarter and 2008, which remain quite high, come down and act as drag on share price appreciation.

Wary Debt Markets

Even though liquidity is being restored to financial markets, depositors remain wary of the banking system as evidenced by the continuing heightened level of the TED spread (Figure 1). The TED spread is one

TED* SPREAD (Figure 1)
Depositors Remain Wary of the Banking System

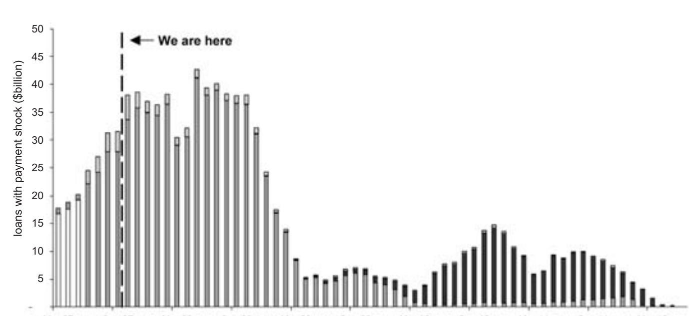


*TED Spread is the ICAP Capital Markets Eurodollar 3 Month Rate – 3 Month US Government T-Bill Yield.
Note: December 31, 2004 – September 30, 2007.
Source: Bloomberg, Tetrem Capital Management.

indicator of risk aversion as it measures what depositors demand to be paid for leaving their money overnight at a bank, as opposed to the relative safety of investing in U.S. government securities. It is signaling that, while the worst of the crisis is behind us, we are not yet out of the woods.

One of the reasons that the debt markets remain wary is that there is a continuing concern over the future default rates of mortgages as housing prices continue to decline. The worst of the sub-prime mortgage debt carries adjustable rates. Many of these mortgages were sold with very low interest teaser rates that will reset to higher rates throughout 2008 (Figure 2).

MORTGAGE RESETS ARE JUST BEGINNING (Figure 2)
$773B in sub-prime mortgages yet to experience payment shocks

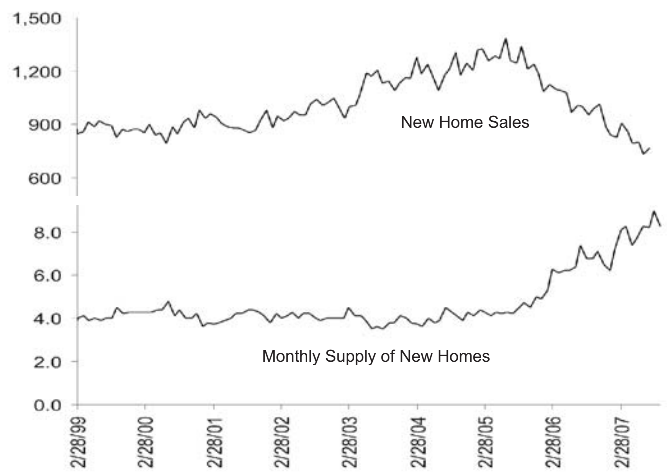


Note: Securitized sub-prime mortgages only. As at May 2007.
Source: Loan Performance, Deutsche Bank.

Not only were home buyers enticed by low interest rates, but they were also able to purchase houses with miniscule downpayments. The fear is that mortgage holders will simply walk away from their homes and default on their mortgages rather than continue to finance an asset where their equity is now negative.

In our July newsletter we wrote that we were researching housing companies as a potential contrarian investment opportunity as their share prices have suffered steep declines. Thus far we have not made any investments. The shares are becoming inexpensive but the future remains murky and we have been able to find better investment opportunities elsewhere. The supply of new homes continues to grow while home sales continue to fall (Figure 3). Until it is clear that inventory is no longer building and that the trough in housing is near, the housing companies will remain somewhat speculative investments. They are still on our investment radar as we believe there will be a good entry point sometime over the next 12 months.

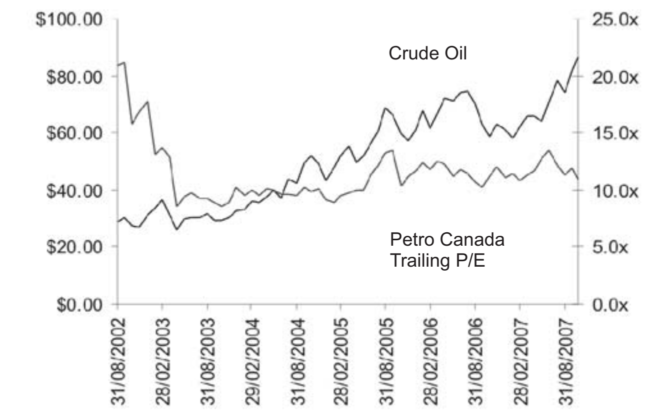
HOUSING CONDITIONS WORSEN (Figure 3)
Still Early to Buy Housing Stocks



Energy Undervalued

We continue to favour the energy sector. While the price of crude oil rises to new heights, the valuation of energy stocks remains muted. Petro-Canada trades at under 12 times earnings, which is effectively at the same level of the past five years, a period when crude oil went from the high $20's to over $80 per barrel (Figure 4). Petro-Canada and other oil companies should be getting higher valuations for their reserves in the ground, but that is not happening. To our contrarian eyes it appears that investors continue to doubt the longevity of the oil cycle and are waiting for oil prices to retreat back to $40. We feel that is highly unlikely and therefore creates an excellent investment opportunity. It remains our view that the secular out-performance of oil companies will not end until they are at much higher valuations.

ENERGY STOCKS REMAIN INEXPENSIVE (Figure 4)
Re-valuation Still to Come



Oil Price vs. Trailing P/E Petro Canada

Our Portfolios

Our performance this year has been mixed. Tetrem's U.S. Equity Composite is up 11.0% year to date, slightly ahead of the 9.1% total return posted by the S&P 500. We moved ahead of the S&P 500 during the quarter by gaining 3.6% vs. the 2.0% return of the S&P 500. Our U.S.-based clients are very happy, however, owning U.S. equities has not been a pleasant experience this year for Canadian clients as the Canadian dollar has surged nearly 17% against the greenback, effectively eating up all of the U.S. equity gains when returns are translated back to Canadian dollars.

In Canada, we started off the year relatively strongly in the first quarter. However, as the market has become more and more momentum-driven, we have lagged the benchmark S&P/TSX Composite Index which returned 2.0% for the quarter and 11.2% year-to-date. Tetrem's Canadian Equity Composite increased 0.5% during the third quarter and is now up 7.4% year-to-date. This performance is disappointing on a relative basis, but we are happy with the returns on an absolute basis. Momentum-driven markets do not favour our style of investing. Our value discipline leads us to sell our winners early and to look for value opportunities in the laggards. Through extended investment cycles, we believe our style of investing invariably wins out; however, we do go through periods where we lag. The risk of jumping on the momentum band wagon is just too great and, quite frankly, our investing DNA would not allow us to do so.

Although our U.S. Equity Composite is ahead of the S&P 500 year-to-date, most value managers have lagged as the momentum phenomenon has taken hold across all equity markets. As mentioned earlier, we have been fortunate to own a number of companies in the U.S. that have been swept up in the momentum surge. Additionally we have been under-weight in financials and consumer discretionary stocks, two groups that have lagged. However, we have been buying financials and warming up to consumer discretionary stocks such as retailers. Both are now out-of-favour and becoming inexpensive. At the same time we have been selling our holdings that have become momentum stocks. Apple is the most obvious example of this, but we have also recently sold off our last share of EMC as it has rallied 87% since we first bought it in June of 2006. Momentum markets eventually die a violent death. When that happens it is our desire to avoid the slaughter by owning shares of companies that offer the best possible margin of safety.

Given our concerns with the rapid rebound in share prices from the August lows, the speculative nature of the current momentum-led market, declining earnings expectations, and continued concerns with the debt markets, we have used some of the recent market strength to raise cash levels. Cash in all managed accounts had been drawn down as we had used the summer swoon to buy shares of companies that had traded down to cheap valuations. As attractive investment opportunities present themselves, we will put the recently increased cash levels back to work by buying the shares of companies that have excellent risk-reward characteristics.

Daniel A. Bubis, CFA
President & Chief Investment Officer

About Tetrem

Tetrem Capital Management offers money management services to institutional and select high net worth clients. Our investment mandates are focused on Canadian and U.S. equities, rooted in our long-standing contrarian value style and tailored to the specific and unique needs of our clients.

Investing is our profession and we are committed to doing it well. Our experienced team is diligently focused on preserving and growing the assets of our institutional and private clients.

We are contrarian value investors. Our primary focus is seeking out and investing in undervalued companies. For each of our investment mandates, we utilize quantitative and fundamental analysis in our rigorous stock-selection process.

For more information about Tetrem Capital Management please visit our website, www.tetrem.com, or call and ask to speak with us about our investment services.

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TETREM'S CANADIAN EQUITY MANDATES

	Annualized Returns to September 30, 2007						Calendar Year Returns				
	Last Quarter	Year to Date	1 year	3 year	5 year	10 year	2006	2005	2004	2003	2002
Tetrem CDN Equity	0.55%	7.44%	15.12%	17.37%	18.53%	12.35%	9.17%	31.57%	15.05%	25.48%	12.07%
Tetrem CDN Equity Value Plus	0.79%	8.23%	15.78%	18.08%	18.68%	13.06%	9.53%	30.05%	14.88%	25.00%	8.15%
S&P/TSX Composite Index	1.99%	11.22%	22.81%	20.16%	20.35%	9.11%	17.26%	24.13%	14.48%	26.72%	-12.44%

TETREM'S US EQUITY MANDATES

	Annualized Returns to September 30, 2007						Calendar Year Returns				
	Last Quarter	Year to Date	1 year	3 year	5 year	10 year	2006	2005	2004	2003	2002
Tetrem US Equity	3.56%	11.02%	17.94%	19.17%	18.98%	10.99%	19.91%	15.11%	15.92%	23.17%	-1.94%
Tetrem US Equity Value Plus	5.12%	14.22%	20.34%	21.83%	21.30%	12.41%	18.47%	21.95%	14.76%	30.51%	-2.41%
S&P 500	2.03%	9.13%	16.44%	13.14%	15.45%	6.57%	15.79%	4.91%	10.88%	28.68%	-22.10%

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Performance Disclosure

Canadian Equity figures as of September 30, 2007. Performance based on an audited equity-only (excluding cash) composite of all segregated accounts until December 31, 2003. From January 1, 2004 to present, performance is based on the unaudited Tetrem Canadian Equity composite. Performance from January 1, 2004 to December 31, 2004 is based on an equity-only (excluding cash) composite of all segregated accounts. The calculation of performance returns excludes expenses and is based on a monthly valuation using the modified-dietz methodology.

Canadian Equity Plus figures as of September 30, 2007. Return calculated from audited NAV. Performance returns calculated include operating expenses, but exclude management fees.

U.S Equity figures as of September 30, 2007. Performance based on an audited equity-only (excluding cash) composite of all segregated accounts until December 31, 2003. From January 1, 2004 to present, performance is based on the unaudited Tetrem U.S. Equity composite. Performance from January 1, 2004 to December 31, 2004 is based on an equity-only (excluding cash) composite of all segregated accounts. The calculation of performance returns excludes expenses and is based on a monthly valuation using the modified-dietz methodology.

U.S Equity Plus figures as of September 30, 2007. From May 1997 to May 2006, return calculated from audited weekly NAV, closest to month end. Performance returns calculated include operating expenses, but exclude management fees. From June, 2006 to present, the calculation of performance returns excludes and is based on a monthly valuation using the modified-dietz methodology.

Tetrem's mandates are available to institutional investors such as pension plans, group retirement plans and foundations and certain individual investors who meet specified investment criteria. The mandates' performances are not guaranteed, the values change frequently and past performance may not be repeated.