ROMC FUND

2007

ANNUAL REPORT

For the three months ended December 31, 2007

ROMC Fund service providers

Administration & enquiries

Commonwealth Fund Services
Suite 3402
130 Adelaide Street West
Toronto, Ontario M5H 3P5

Our contact: Alex Chapman
Email: ac@commonwealthfundservices.com
Telephone: 416 361 4563
Fax: 416 361 0294

Audit	Investment counsel	Legal counsel
Burns Hubley LLP	MAMGMT Fund Services Ltd.	Owens, Wright LLP
90 Allstate Parkway	219 St. Leonards Avenue	Suite 300
Suite 501	Toronto, Ontario	20 Holly Street
Markham, Ontario	M4N 1K8	Toronto, Ontario
L3R 6H3		M4S 3B1

ROMC Fund results

Calendar year		Owners' return
2007 *	________________________________	9.1%

Total return is shown in Canadian dollars, net of expenses
* From October 1 to December 31, 2007

To the owners of ROMC Fund:

When you think of ROMC, think of a holding company. Our holding company's job is to earn a positive economic return on shareholder capital. We will generally do this through ownership in business. At present, we are part owners in 6 businesses. That number may change over time.

This letter, including the enclosed audited financial statements, is the only formal management reporting I have planned for owners. It will be sent to you around this time of year. In it, I will try to inform you about relevant issues impacting ROMC. Without a doubt, the most relevant issue will be our economic progress. One year's progress, or lack thereof, will not make or break ROMC. But our progress over a period of five or so years will.

In 'The Intelligent Investor', author Benjamin Graham described how the relationship between business value and stock prices can, at times, vary enormously. He stated: "In the short run, the market is a voting machine but in the long run it is a weighing machine." My job is to add weight to ROMC. In business, fewer things are considered healthier than a large and expanding girth.

Reported results

Our gain in market value in the last quarter of 2007 was $199,918 which increased our per-security net asset value by $0.91, or 9.1%. This mostly represents the amount of 'votes' we received over the quarter and is of little value in the short run.

If you look at the table below, you will see four sets of figures. The first column shows the total return for ROMC's owners, which is the same figure quoted by all mutual funds. The second column shows the approximate after-tax return for ROMC, which really matters to you. The third column shows the change in the Consumer Price Index, commonly known as the rate of inflation. And finally, the fourth column shows the relative return between the approximate after-tax return on ROMC and the rate of inflation[1]:

[1] After-tax return is a rough estimate and may not represent an individual shareholder of ROMC Fund. Everyone's tax situation is unique. Inflation = Change in consumer price index; source: Bank of Canada (www.bankofcanada.ca)

Calendar year		Total return	Owners' After-tax return	Inflation	Relative results
			(1)	(2)	(1) - (2)
2007 *	______________	9.1%	7.0%	0.1%	6.9%

Total return is shown in Canadian dollars, net of expenses

Your earnings on savings are taxable. Even your RRSP is only tax deferred. And though everyone's tax situation is unique, I think it best to have an approximate idea of where we stand on an after-tax basis. Our after tax return must keep pace with inflation. Or perhaps better said, our net return must at least offset the loss of purchasing power over time. And in an environment of rising prices, purchasing power is constantly lost. As my father-in-law likes to tell me: "There are only two directions in life – up and down – and even up can be down." If over a certain amount of time your after-tax investment experience in ROMC does not compensate for your loss of purchasing power, even if the absolute result is positive, your position relative to the economy at large is poorer.

Economic results

While I have not shown it in the results section, our gain in economic value in the last quarter of 2007 was $80,295. On a per-security basis it was $0.37, or 3.7%. This represents the amount of 'weight' we added during the period and is of great importance.

To illustrate why economic value and market value differ dramatically to us in the short run, let's return to Benjamin Graham and imagine that ROMC is a publicly traded company with shares listed on a stock exchange. Every day our market value fluctuates; sometimes higher, other times lower depending on the collective mood of people buying or selling our shares. On occasion, the mood is frightful about our prospects and our shares sell for a pittance. On others, the mood is euphoric and our shares won't sell for the moon. Ben Graham gave the collective mood the name "Mr. Market" and suggested he had a less than firm grip on rational thought. His point being, at times, a buying or selling frenzy will occur but have little to do with the economic value of our investees which continue to churn out reasonable returns on capital from one year to the next. In the long run, market performance can only hope to equal economic performance – so better to focus on economic performance. Mr. Market can be useful, but only as counterparty. This kind of thinking is unpopular on Bay Street because it isn't subject to emotion and nothing pays 'The Street' better than the emotions of Mr. Market.

Insurance

Insurance is a big deal to ROMC. Two things are vital in a successful insurance operation – underwriting discipline and investment prowess. Because insurers take in money in the form of premiums which they eventually pay out in the form of claims, the value of an insurance business is based on what is done with the money received until 'eventually' arrives. Investment prowess allows for an attractive return on what effectively is borrowed money and underwriting results determine the cost to borrow.

Last year, our insurance investees, in aggregate, made money on underwriting – meaning they were paid to hold investment funds. The return on those funds was approximately 10%, an attractive result for sure. Overall, our investees enjoyed a pretty terrific 17% return on equity. Our return was 12% due to having acquired our investees at a premium to their equity.

Insurance is subject to estimation error. No insurer is 100% certain that what they claim as losses in a given year will be the actual amount eventually paid out. So, the more 'optimistic' underwriters tend to look great for a while until reality catches up with them. Depending on the type of insurance business, reality can take many years to show itself. In order to defend ROMC against the misinformed optimist, we have acquired insurance investments run by managers who have many years of experience and, in aggregate, have actually over-estimated claims in their time.

Another reality in insurance is that not all managers are good investors. And in a world of increasingly complex and seemingly easy investment 'opportunities' developed at firms like Dewey, Screwem & Howe and sold by Mr. Right-Now, these insurers fail to earn positive returns on invested funds. In order to avoid this kind of disappointment, ROMC has chosen to own insurance investments with common sense-oriented, responsible managers who concern themselves with risk as well as return.

Healthcare

When I say healthcare I mean the pharmaceutical industry, a normally remarkable generator of economic returns. Last year was different. Our pharma-investments, in aggregate, performed poorly on paper. Reported earnings were depressed by increased costs associated with poor past capital allocation decisions and legal settlements.

From my observation, the pharmaceutical industry, while healthy, has suffered from less than stellar management decision-making over the past few years. And shareholders are fed up. Unlike many industries, pharma is not considered cyclical. It is an industry where internal execution and therefore the quality of management & staff make the difference between success and mere survival. But that is not the case when managers act like sheep in making strategic decisions. The 'if others are doing it, it must be right' mentality in the industry over the last few years created a colossal amount of misspent shareholder funds, which has now been found out. The authors of error are long gone with their fabulous perks in tow, but ROMC has them to thank, for without their assistance incumbent shareholders wouldn't be exasperated and wouldn't be transferring us their ownership of what appear to be solid businesses selling at low prices.

We have acquired ownership in this industry when an arbitrage opportunity appears to exist; arbitrage being a fancy word for difference. And the difference I see is between reported earnings and cash earnings. For 2007, cash earnings[2] at our operating businesses were 169% of reported earnings. It is my hope that the difference between these two results will diminish in favour of those who follow the cash. However, it is anything but guaranteed. So ROMC is taking a show and tell approach, demanding to be paid handsomely to wait it out. Of the reported earnings produced by our pharma-investments in 2007, 109% was paid out in the form of normal dividends. Those dividends have been announced to increase in 2008. While the long-run prospects for the industry may be exciting, waiting for them is tedious. But nothing says patience like a large and increasing bribe... I mean dividend.

At year end, our pharmaceutical investments represented 21% of ROMC's market value. At time of writing, our allocation to the industry had risen to 25%. I expect this trend to continue as long as the cash flows to us at attractive rates.

Retail

Our retail investments are unique – so far. Retailers, like common thought on sharks, die if they stop moving. A retailer that is not growing is considered as good as dead. In order to grow, capital investment in space and inventory is typically required. So, flourishing retailers typically report earnings that are vastly in excess of what they actually produce in the form of cash. Because capital expenditures (investments in the future) are well above depreciation charges (investments of the past), some retailers report negative cash earnings. That would be a no-no for ROMC.

In fact, reported and cash earnings for our investee were almost identical in 2007. By definition, that should mean imminent demise. But sales were up 50% in the year and earnings were up 282%. Return on equity was a remarkable 75%. Because we bought our share of the business at more than 5 times book value, the return on our capital was 14%. Not dead just yet.

Before you start spending it like you've got it, remember that good economic results in our free enterprise economy are subject to competitive appropriation and nowhere is it probably easier to appropriate than in retail, where everything is on display.

In aggregate, we paid a premium of 50% over our investees' own net worth (1.5 times book value). In order for ROMC to earn an annualized 10% economic return on our carrying value, our operating businesses would need to earn at least 15% on theirs. Considering the average company in the S&P 500 earned 13% in 2007, it looks like they have our work cut out for them.

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[2] Cash earnings are defined as reported earnings plus depreciation & amortization less capital expenditure.

Management at our investees understands the 'only two directions in life' rule described earlier. In their attempt to compensate for the loss of purchasing power on an after-tax basis, they typically need to invest more capital to produce more earnings. And what better capital to use than that portion of earnings not paid out as dividends to shareholders. These retained earnings add to shareholders' capital and can be spent pretty much any way management sees fit. Sometimes earnings retained are wasted on investments with poor economic characteristics. Other times, they are transferred to employees through the repurchase of employee-optioned shares at prices which have nothing to do with value for money. Rarely, but typically in the case of our investees, they are allocated to improving and growing existing operations for the benefit of shareholders.

Over the last 3 years, our businesses retained a total $52.5 billion of earnings. During that time, additional earnings amounted to $11.7 billion. This suggests that for every dollar retained $0.22 of additional earnings was produced, or 22% return on marginal equity. This figure is higher than the 16% return on equity for our investees as a whole, further suggesting that management is spending shareholder funds well. That's not all. The market value of our investees increased $97.8 billion during the last 3 years, suggesting that for every dollar retained from earnings, $1.86 of market value was created. With investments like these, owners should want management to retain 100% of earnings and avoid dividends. While not exactly our case, our investees retained 84% of ROMC's share of reported earnings versus an S&P 500 average of 58%. And ROMC still sports a dividend yield of 2.1%, similar to that of the S&P 500.

Expenses

There are two types of expenses at ROMC: 1) operating expenses which cover administration and audit services; and, 2) management fees which cover yours truly (I hope).

Management fees are a little different at ROMC. There is no fixed fee; I have <u>no</u> idea how much I may earn, if anything, throughout the entire calendar year. I get paid if we successfully increase market value and, as mentioned, that will only come about as a result of successfully increasing economic value. To illustrate, take the S&P 500 equity index. From 1998 through 2007, the average economic return was actually below 5% per year. Meaning, if you had bought the index in 1998, you would have earned an economic return (in local currency) of less than 5% per annum, but you would have paid next to nothing in fees. Your market return including dividends was almost identical. So why would you risk your savings elsewhere? I suppose the answer is – to do better. But in Utopia, the halls of Valhalla or wherever fairy-tales come from, you should only pay if indeed you do better. Try that on your broker.

Expenses in 2007 were $64,247. So our gross asset value per-security increased $1.20 per share, or 12%. Administrative/audit expenses accounted for $4,818 of the total. $59,429 was paid to me. Because we were only running for 3 months in 2007, the required rate of return before management fees kicked in was 1.5%. 11.8% operating return (gross return less administrative expenses) minus 1.5% required return = 10.3% excess return, of which I received 25%.

March 26, 2008 David McLean