ROMC FUND

2009

ANNUAL REPORT

For the twelve months ended December 31, 2009

ROMC Fund service providers

Enquiries & administration

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
Burns Hubley LLP
90 Allstate Parkway
Suite 501
Markham, Ontario
L3R 6H3

Portfolio management
MAMGMT Fund Services Ltd.
219 St. Leonards Avenue
Toronto, Ontario
M4N 1K8

Legal counsel
Owens, Wright LLP
Suite 300
20 Holly Street
Toronto, Ontario
M4S 3B1

ROMC Fund results

Calendar year		Owners' return
2007 *		9.1%
2008		5.7%
2009		26.0%

Annual gain since inception	18.1%
Overall gain since inception	45.3%

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

"Bull markets are born on pessimism,

Grow on skepticism,

Mature on optimism,

And die in euphoria."

John Marks Templeton

Disclosure:

The letter you are about to read contains opinions of the author as well as estimates and unaudited figures. The author has attempted accuracy. Some comments could be considered forecasts. Terms in *italics* are described in the glossary at the end of this letter. Only owners receive audited financial statements.

To the owners of ROMC Fund:

In 2009, our per-security net asset value increased $2.99 or 26%. Since inception, a little over two years ago, our net asset value per-security (our market value) has increased from $10 to $14.53, an annual growth rate of 18%.

The result continues to meet the all-important test of increasing after-tax net worth by more than the rate of inflation, as illustrated below:

		Owners'		
Calendar year	pre-tax return	after-tax return[1](1)	Inflation[2] (2)	Relative results (1-2)
2009	26.0%	19.9%	1.3%	18.6%
Since inception	45.3%	34.0%	2.6%	31.4%

It took **NO** skill to earn a positive return in 2009. I may as well have thrown darts at the stock pages as give any time to thinking about risk. In fact, ROMC's result was worse than that of some 'know-nothing' investors: Had you put your savings in a Canadian equity index fund last year, you would have beaten ROMC. Skill, if I may, was required in years prior and undoubtedly will be handy in future. But some would suggest that ROMC is only as clever as its latest result. Had I not been here before, I might take it personally. I think our present predicament worth suffering, however, given ROMC's investments; 'investments' being the key word. ROMC does not indulge in speculation, a practice of buying an asset today in the hopes of selling it on at a higher price 'tomorrow', typically requiring more imagination than business acumen and, like passing a hot potato, best done with haste—something I find disagreeable, increasingly so as I age.

At ROMC, we are not concerned with what someone will pay for our investments tomorrow. What concerns us is the amount our dollars generate in earnings and interest. Each of us wants (repeat after me) a "Return on My Capital". Yes, and if 2010 is even half as good as 2009, our dollars will continue to earn an enviable rate. This would please me more than if the market price of our holdings rose, through speculative fervour, to levels where we would be forced—by common sense—to sell.

By my calculation, ROMC enjoyed close to $1 million in economic profits derived from our investments in 2009. In calculating economic profits, I count the annual earnings[3] associated with our

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[1] After-tax return is a rough estimate and may not represent an individual shareholder of ROMC Fund.

[2] Inflation = Change in consumer price index; source: Bank of Canada (www.bankofcanada.ca)

[3] Earnings for common equity investments in banking, healthcare and retail are GAAP reported earnings. Earnings for common equity investments in insurance are GAAP comprehensive earnings. Comprehensive earnings = GAAP reported earnings + other comprehensive income. Shares used are quarterly-weighted.

common equity investments and add to that any other net income for the year (like preferred dividends, less interest expense).

Understanding the difference between economic returns and market returns is key to understanding ROMC. In the short-term, earnings and interest derived from our holdings may not even remotely reflect our market return. Just think back to 2008 when many public companies produced positive earnings and yet their share prices declined dramatically. The correlation doesn't usually work over brief periods like one, two or even a few years. But over the long haul, it should. The fact that ROMC's market return has closely mimicked its economic progress in the short time since its inception is unusual and won't last.

Not all of the economic profits earned last year returned to ROMC's bank account. We received only $443 thousand in dividends, or 47% of the total. It is my job to ensure that what was left behind is in capable hands (and I want to keep my job).

		Value at 31/12/09	% of assets
Banking	**(Cost $2,821,862)**	**$3,121,532**	**35%**

We are now in the banking business. In describing to you our investee, I will focus on three stand-out measures: (i) net interest margin, (ii) return on assets, and (iii) franchise value.

(i) Banks lend money they borrow from depositors. The difference between what they lend for and what they pay depositors is their profit and is known in banking circles as net interest margin. I would estimate that the average bank in the world today earns a net interest margin of just over 2%. Our bank earns over 4%.

(ii) A typical bank earns less than 1% on its assets, a low number for investors seeking a 10%+ return on their capital. In order to turn 1% into 10% or more, banks leverage their assets meaningfully. Imagine that all banks wish to target a 20% return for shareholders. The average bank, with a 1% return on assets, needs to leverage itself 20:1. Our bank has averaged just shy of 2% return on assets over time so its leverage ratio need only be 10:1. This is material, the bank with a higher return on assets requires less leverage. And leverage = risk. In a 20:1 ratio, a 5% decline in assets wipes out shareholders. In a 10:1 ratio, a 10% decline is necessary to be wiped out. In the current economic malaise, the average bank has probably already lost more than 4% of assets.

(iii) One of the principal reasons a bank can generate a high net interest margin and return on assets is 'franchise value'. A bank that has a reputation for sound lending and commendable service, usually at a high cost to borrowers and depositors alike, has such value. When you trust your bank, you are less likely to switch to another even if you can borrow at a lower rate or earn a fraction of a percent more on your savings account. In the recent financial meltdown, banks with franchise value got stronger as depositors switched from their competitive but less sturdy institutions in order to safeguard their capital. Few will leave as things normalize, even though they may be charged more. The ING man said "money doesn't grow on fees" but he wasn't talking about our money which will grow handsomely on what our bank, which has remarkable franchise value, charges its loyal customers.

		Value at 31/12/09	% of assets
Insurance	**(Cost $3,967,850)**	**$4,098,226**	**46%**

For the last two years, I have forecasted that the party is over in insurance and yet our investees continued to deliver remarkable returns on our capital. Hmm...

		Value at 31/12/09	% of assets
Healthcare	**(Cost $443,555)**	**$486,184**	**6%**

The accounting arbitrage between what our investees were reporting in earnings on a GAAP basis and what they were earning in cash has pretty much played out and we have reduced our holdings.

		Value at 31/12/09	% of assets
Retail	**(Cost $210,626)**	**$343,605**	**4%**

Our retail investee has weathered the recessionary storm with remarkable ease, demonstrating why an investor should choose quality and sustainability over fad. 'Better to buy a great business at a fair price than a fair business at a great price.'

		Value at 31/12/09	% of assets
Preferred equity	**(Cost $2,387,911)**	**$3,428,151**	**39%**
Liabilities		**($2,690,026)**	**-31%**

Yet again, I have mortgaged ROMC. Last year, I bought preferred equity. Preferred equity is really debt but because it pays dividends (not interest) it is considered equity. And because it ranks just ahead of common stock in liquidation it is called preferred. Anyway, I bought some. And thinking that what I was buying would have little trouble staying current on dividend obligations, I bought on margin. Before you lump me in with the equivalent of some modern-day investment bankers in the order of fiduciary duty, let me explain. On average, we were paid a cash yield of more than 13% on cost, the bank's cost, for which we were asked to pay, on average, a little more than 3%. In banking terms, a spread of 10% (the difference between the earned rate and the owed rate), is the equivalent of discovering El Dorado.

Expenses

If we were to add back administration and manager remuneration expenses, ROMC's 2009 gross asset value per-security increased $3.85, or 33%. Administration expenses, including audit, accounted for 0.3% of average net assets for the year. Manager remuneration was 6% of average net assets for the year.

ROMC operating expenses for 2009

Administration	$22,313
Commissions	$16,800
Manager remuneration	$442,922
	$482,034

Last year you paid me well – perhaps for some, too well. In my defence I will only add insult to injury. As an ROMC owner, my family earned more than 3 times my wages, on an after-tax equivalent basis. If I were sitting in your chair I would not be greatly put out. There are few managers who can claim they earn the bulk of their money with their investors instead of off them. And because my wife doesn't read these letters, I can tell you that I invested the equivalent of 35% of my salary (65% after-tax) back into ROMC in 2009.

Taxes (for taxable accounts only)

In 2009, we were forced into a capital gain as one of our coveted investees was acquired, for cash. That means, for some, taxes are owed. While we pay only ½ of our marginal rate on such profits, having been realized means we have less capital to work with going forward. To illustrate, imagine the takeover had not been successful. Our cost and gain together would still be compounding at the business' economic rate of return. Now, with 23% of that gain going to our 'partner-for-life', we are compounding less than 90% of our total. And we have to find a suitable replacement – that business was generating more than 20% return on our capital!

Deferred income taxes, like those accruing on most of our investments, are real liabilities, but they have no cost. The government doesn't charge us interest on what is effectively a loan, a loan that can grow almost indefinitely and without limit as to amount. (I know of no banker offering similar terms.) Looked at this way, deferred tax liabilities become an enviable source of capital, to be protected, nurtured and grown. This fact has not escaped me. Of the total gain in ROMC since inception, only 23% has been reportable on your T1/T2.

Closing comments

ROMC breaks taboos. Investment research is done by a score of one, with no analysts or underlings to confuse matters. Our headquarters presently consist of my home study and worst of all for some, we have relatively little capital. It amuses me to hear people suggest that a manager is not serious unless he/she has an office with masses of administrative support on the payroll. That unless there is a billion dollars under management, there is something wrong.

I think people say these things because that's what they hear from money managers who emphasize growth through marketing rather than compounding. If an investor were to think what is really best for them, their tune might change. ROMC's small size, for example, is good for shareholders. Why? It's a lot easier to spend $10 million well than to do so with $10 billion. And spending money well, i.e. for maximum total real return after taxes, is what matters. Not having an office and minions milling about saves time, money and can improve performance. How? Competence doesn't come from committees and consensus, it comes from common sense. Warren Buffett tells us: "If I need a second opinion, I look in the mirror." His partner, Charlie Munger, suggests: 'The opulence at head office is often inversely related to the substance of the firm.' In the end, ROMC will be judged on its results, not on its headcount or for that matter its office furniture thread-count.

It has been noted that my family tends to mind its pennies. When pressed to explain, we usually offer something about not wanting to attract the wrong sort of attention. ROMC's goal is no different, we are out to impress the right sort of people – us!

March 26, 2010 David McLean