ROMC FUND

2010

ANNUAL REPORT

For the twelve months ending December 31, 2010

ROMC Fund service providers

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ROMC Fund results

Calendar year	Owners' return
2007 *	9.1%
2008	5.7%
2009	26.0%
2010	6.9%

Annual gain since inception	14.5%
Overall gain since inception	55.3%

Owners' return is shown in Canadian dollars, net of expenses, and on a master series-equivalent basis

* From October 1 to December 31, 2007

"I think the future of equities will be roughly the same as their past; in particular common-stock purchases will prove satisfactory when made at appropriate price levels.

It may be objected that is far too cursory and superficial a conclusion; that it fails to take into account the new factors and problems that have entered the economic picture in recent years - especially those of... the energy crisis the ecology-pollution mess and even the movement towards less consumption and zero growth. Perhaps I should add to my list the widespread public mistrust of Wall Street as a whole, engendered by its well-nigh scandalous behavior during the recent years in the areas of ethics, financial practices of all sorts and plain business sense."

Benjamin Graham - 1974

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 2010, our *per-security* net asset value increased by $1, or 6.9%. Since inception, a little over three years ago, our net asset value per-security (our market value) has increased from $10 to $15.53, an annual growth rate of 14.5%.

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'		
	pre-tax return	after-tax return (1)	Inflation (2)	Relative results (1-2)
2010	6.9%	5.2%	2.4%	2.8%
Since inception	55.3%	40.7%	5.0%	35.7%

But it is *economic value* that matters. Without attractive gains in that measure, ROMC's market return will wilt, and eventually our results will be no better (and probably worse) than the broad equity market. Ever horrified by such a prospect your manager soldiers on in search of attractive economics. Last year, by chance, we came into some.

Economic results

When calculating our economic results, things are organized according to asset class: (i) Common equity investments, and (ii) Fixed income & Other. While (ii) is a straightforward addition of net interest earned + preferred dividends received +/- realized gains/losses not associated with common equity investments, (i) is a little more involved. Because ROMC is really an equity fund, we typically have a large percentage of our assets in common equity investments. These usually pay us little in the way of dividends (which appear in our financial statements) compared to the earnings they generate (which do not appear). So I calculate economic results based on the earnings generated from such investments, like this:

> ROMC owned a quarter-weighted 1,000 shares of ABC Company last year and it generated earnings of $2 per share. Our economic profit from ABC Co. was 1,000 * $2, or $2,000.

I perform this advanced math for all of our common equity investees, add up the answers, and thus come to (i), the economic results of our common equity investments.

In the spirit of full disclosure, I will tell you that my way of calculating ROMC's economic results does not conform to generally accepted accounting principles (GAAP). Our auditors offer no opinion on the accuracy or veracity of my calculations. But since I use this very process to organize my thoughts and assess investments for ROMC, I think it important that I lay it out for you. Otherwise, you'll have little idea as to ROMC's real value and that may lead you to make ill-informed decisions about ROMC and your savings.

With calculated and aggregated economic results, ROMC can be compared to other public companies and even with equity indexes, all of which use similar methods to report their earnings. The following table shows data for both ROMC and the *S&P 500 Index*:

($Cdn)	ROMC Fund	S&P 500 Index
Economic profit per-security (a)	2.06	79.23
Average market value (b)	14.88	1,169.08
Earnings yield (a ÷ b)	14%	7%
Price/earnings multiple	7	15

On average, over time, I expect our market return to equal our earnings yield. But as I've attempted to convince you in letters past, these metrics do not follow the same route each year. In 2010, they weren't even in the same neighbourhood. Remember, investing takes time. Just because 365 days have passed does not automatically make all market performance equal to all business performance.

For those familiar with price to earnings ratios (P/E), an earnings yield of 14% means ROMC had a P/E of 7 in 2010. (P/E is the inverse of earnings yield.) The equivalent figure for the S&P 500 Index, with an earnings yield of 7%, was 15.

Below, I present ROMC's economic profits for the last two years. Bear in mind, these figures are calculated using the non-GAAP method I outlined above.

($Cdn)	2010	2009
Common equity investee earnings	954,682	1,008,337
Fixed income & other	502,500	172,728
Economic profit from investments	**1,457,183**	**1,181,065**

2010 common equity investee earnings declined 5% from 2009. Not the result you would expect considering that ROMC's capital grew more than 40% over the year (meaning, we held more of our investees during 2010). An increase in the Fixed Income & Other category is the reason that our total economic profit was above 2009. Although the result looks odd, it isn't bad. Why? In 2010, our *economic return on capital* (attributable to investments) was an enviable 16%. It wasn't as enviable as 2009's 20%, but had we owned the S&P 500 through an index fund we would have earned only about 8% last year.

Let's dig deeper into what the term *return on capital* means. It is an important measure – one might say it is the essence of ROMC (which stands for Return on My Capital). For that reason, I would very much like owners to understand it. Economic return on capital is a comparison of our economic profit to our cost of investment. In our previous example of ABC Co., imagine we purchased our average interest for $20,000. The economic return on our capital would be: $2,000 in 2010 economic profits ÷ $20,000 cost of investment = 10%.

Below, I list our return on capital calculations for 2010:

($Cdn)	**Economic profit**	**Capital invested**	**Return on capital**
Banking	432,076	4,767,827	9%
Insurance	448,477	3,672,642	12%
Retail	74,130	782,360	9%
Fixed income & other	586,299	3,365,472	17%
Borrowings	(83,798)	(3,317,635)	-3%
Attributable to ROMC investments	1,457,183	9,270,665	16%
ROMC expenses (incl. brokerage)	(94,819)		
Attributable to ROMC owners	1,362,364	9,270,665	15%

To stand a chance against our formidable foes, taxation and inflation, our economic return on capital probably needs to be in double digits over time. While such results would be pleasing, they are not guaranteed. The future awaits us with many twists and turns so I ask you not to count the past as representative of what lies ahead.

Banking

Banking is now a major source of economic profit for ROMC, accounting for 1/3 of our 2010 total. Last year, banking provided an economic return on our capital of 9%.

Keep in mind that 2010 profits were below potential. In aggregate, our investees produced *reported earnings* of 33% of pre-tax, pre-provision profit. A normal year would see 50%+. Banking continues to feel the real estate and economic malaise suffered in much of the developed world during 2007/8.

Insurance

Our insurance investees had respectable results in 2010, with an economic return on our capital of 12%; short of 2009's remarkable 27%, but nothing to sneeze at.

Because our insurers carry large investment portfolios, they tend to have unrealized investment gains (and sometimes losses) from year to year. When such gains (losses) are added to *reported earnings*, they form *comprehensive earnings* and tell the true tale of our investees' economic progress. The difference between 2010 and 2009 economic profits can be explained by the magnitude of unrealized investment gains enjoyed in 2009 but not repeated in 2010. Gains of this nature are an important part of our insurers' value to us. They may be unpredictable in their timing and size, but history has proven them to be material. When it comes to insurance, ROMC subscribes to the theory of "better a lumpy 15% return than a smooth 12%".

It is worth noting that of the $448,477 in *comprehensive earnings* associated with our insurers in 2010, only $23,690 arrived in our bank account in the form of dividends. (See why I focus on earnings?)

We have held our same insurance investees, in varying amounts, pretty much since inception. Long-term ownership is not fashionable. High-frequency trading circles would consider our style passé and question its fit, as might a member of the fairer sex when trying on new jeans. A question sometimes posed to that special someone and best left unanswered. But since 2007, our insurers have provided ROMC with cumulative comprehensive earnings of $1.2 million, or an average annual economic return on our capital of 15%. So I do not hesitate in telling you that, yes, our insurance investments do make your assets look fat.

Retail

There are few businesses as magical as good retailers: compounding machines able to generate high returns on ever-expanding capital for long periods of time.

To give an example, when we acquired our interest in ROMC's principal original retailer in 2008, it generated an unleveraged return on its own equity of 30%. In 2010, just two years later and despite having grown its equity base by more than a third, it clocked a return of 33%. Businesses that earn high rates on ever-increasing amounts of capital are rare and should be held, tenaciously, for as long as such miracles compound.

The trouble is a lot of market participants know about the compounding charms of good retailers so acquiring them at attractive prices is difficult. In 2010, an opportunity to expand our retail interests presented itself and like the couple absconding from IKEA at sale-time, we were sure to "Start the car!" We quadrupled our investments in this area and, as a result, our 2010 retail economic profits represented 5% of our total (up from 1% in 2009). Importantly, retail provided an economic return on our capital of 9% (8% in 2009).

Fixed Income & Other

We continue to borrow money. For a while now, short and medium-term interest rates have been below the rate of inflation. That means that real interest rates are negative; a phenomenon only experienced during periods of stress, which like it or not, we have "enjoyed" from about nine days after ROMC's launch. The fallout from the real estate, stock market and economic crises of 2007/8 continues to haunt, but has made money cheap for qualified borrowers like ROMC.

Central banks are telling us that currency has little immediate value. News of this sort can confuse savers who have worked to build a surplus of that very product. Some react by squirreling money away in precious metals or other objects-of-desire. We react by increasing our holdings in cash-producing business assets beyond what our net worth dictates. I mean, when borrowing rates are close to 0% and productive assets can be had for... well... a lot more than 0%, sensible savers go shopping.

I am in no way supporting the constant use of debt. Leverage only serves to emphasize the quality of decision-making and should be used only when that quality is high. I do not support, for instance, the approach of many investment professionals in 2006/7 who anxiously bought up low-grade mortgage-backed securities and funded their purchases with borrowings at spreads that you couldn't put a thread through (commonly thinking that ever-more leverage was necessary to eke out an adequate profit). The decision-making underpinning this operation was nothing short of asinine. But I find it almost as ridiculous to suggest that when yields on high-quality, cash-producing business assets are many times the equivalent of government bonds, one should opt for government bonds, or worse – gold. This wrong-way-round thinking pervades our financial markets and promotes the various instabilities witnessed time and time again.

When borrowing to invest, we act like a bank. A bank's function is to borrow deposits and invest them in loans. The difference between what it gets from its loans and what it pays for its deposits is its profit, and is commonly referred to as "spread." ROMC has three rules when engaging in spread investments:

1. We hold securities that I believe are of responsible issuers.
2. We invest at spreads in excess of the best banks' own spreads.
3. We measure spread using current cash payments, not earnings projections.

To date, we have funded our spread investments with short-term debt. It is so named because borrowing rates can change – literally overnight. Faced with such unpredictability, ROMC has looked for large spreads that might withstand the sometimes rapid change in rates. In 2009, our average spread was over 10%. In 2010, it was around 7%. These figures compare favourably with the best bank spread known of just over 4%.

In dollar terms, we produced net income of $502,500 (including realized gains) from our operations in this area during 2010 (up from $172,728 in 2009), with little of our own capital invested. It's not alchemy: it's just common sense that has paid off in economic profit.

Expenses

If we were to add back administration and management expenses, ROMC's 2010 gross asset value per-security increased of $1.09, or 7.5%.

ROMC Operating Expenses

($Cdn)	Amount	% average assets
Administration (incl. audit)	30,054	0.31%
Management	42,335	0.43%
	72,389	0.74%

As I like to remind owners, ROMC has no fixed management fee. Our 2010 market return didn't amount to much and neither did my pay. Unlike in most mutual funds, a remuneration policy of this sort ensures that owners come first. And as an owner myself, I am somewhat put out by last year's performance. But I rest a little easier knowing that the manager feels a good deal worse.

Taxes (for taxable accounts only)

We realized some gains in 2010. As I bragged about in last year's letter, we avoid taking profits on healthy investees in order to use deferrable taxes as a form of capital – without cost or maturity. 2010's capital gains were mostly in fixed income, where one of our holdings was redeemed by its issuer and another was sold at a price above my estimate of its value to us. Our reportable gains totalled $366,295 ($0.71 per-security).

During 2010, we also earned income from dividends and interest (again, predominantly from our operations in fixed income). After netting out expenses, this income amounted to $106,190 ($0.21 per-security).

All told, ROMC still runs at a reasonable rate of tax deferral. Of the overall gain since inception, just over 35% has been reportable by owners with taxable accounts, leaving 65% of the overall gain tax-deferred.

Closing comments

Owners should know by now that no strategic plan exists at ROMC. Our method of acquiring economically-advantaged assets happens only on a reactionary basis. Much like a teenage boy, we don't go looking for adventure, it eventually finds us.

Not having a plan, however, does not mean we lack a goal. Our goal is to maximize real return after-taxes. Our method emphasizes economic progress. In our quest, we use the capital markets – but only to assist us (like money, the markets make a good servant but a poor master).

By remaining faithful to our goal, flexible in our approach and patient, it is possible that we will continue to outperform the general experience in equities, much as we have done since inception.

March 25, 2011 David McLean

Glossary

Figures in this report, unless otherwise stated, are in Canadian dollars. Foreign exchange rates for conversion purposes are sourced from ROMC's administrator: Commonwealth Fund Services.

Per-security or *per-ROMC-security*

Data for ROMC is calculated on a master series-equivalent basis and on an average of the outstanding securities for a given year. Source of security count: Commonwealth Fund Services. For the purposes of this letter, ROMC's securities are the same thing as ROMC's units.

After-tax return

After-tax return is management's estimate of the return to ROMC owners, after paying personal income tax on income and gains. For the calculation, management assumes Ontario as the province of owner residency, the highest marginal rates in effect and that all outstanding shares of ROMC are taxable. The return attempts to take into account the effect of withholding taxes paid at source on income from some of ROMC's investments. There are moving parts to the analysis and it is only meant as a guide. Investors should seek a tax expert to understand their own circumstances. Source of income tax rates: TaxTips (www.taxtips.ca).

Inflation

Change in the Canadian consumer price index. Source of data: Bank of Canada (www.bankofcanada.ca).

Economic results/progress/return/profits

Figures calculated by ROMC's manager to provide owners a behind-the-scenes look at how ROMC's investments perform on a business-like basis. The figures are organized according to asset class:

(i) Common equity investments: because ROMC is really an equity fund, we typically have a large percentage of assets in common equity investments. These usually pay us little in the way of dividends (which appear in our financial statements) compared to the earnings they generate (which do not appear). So I calculate economic results based on the earnings generated from such investments, like this:

> ROMC owned a quarterly-weighted 1,000 common shares of ABC Company over the year. ABC Company generated earnings of $2 per share that year. Therefore, ROMC's economic profit from ABC Co. was 1,000 * $2, or $2,000.

This math is performed for all of ROMC's common equity investees and can be shown separately or in aggregate on a fund-wide basis.

(ii) Fixed Income & Other: a straightforward addition of net interest earned + preferred dividends received +/- gains/losses not associated with common equity investments.

ROMC's economic results do not conform to generally accepted accounting principles (GAAP). Our auditors offer no opinion on the accuracy or veracity of management's calculations. But since the manager uses this process to organize his thoughts and assess investments for ROMC, he thinks it important to describe it. Otherwise, owners will have little idea as to ROMC's real value and that may lead owners, both existing and prospective, to make ill-informed decisions about ROMC and their savings.

Reported earnings

Reported earnings are a company's GAAP/IFRS net income (after corporate taxes).

Comprehensive earnings

Comprehensive earnings are Reported earnings plus other comprehensive income (after corporate taxes). Other comprehensive income measures the unrealized gains/losses in the assets/liabilities (after corporate taxes) of a corporation's balance sheet. Because these gains are unrealized (meaning they have not been sold) they do not generally appear in a company's income statement. Comprehensive earnings are useful in determining economic progress for companies that hold marketable securities (stocks, bonds, derivatives, etc.) whose values fluctuate from one year to the next. Insurance companies usually carry large holdings of marketable securities and therefore potentially meaningful changes in other comprehensive income.

Return on capital

Described as ROMC's economic results ÷ average cost of investment for the year, net of borrowings.

S&P 500 Index

The index is comprised of 500 large-capitalized public companies that do business around the world but who report in the United States. In this report, the index represents the general experience in equities as well as the general experience in business. Data on index-wide, industry-specific and individual company sales, earnings, dividends, and equity (book value) make it one of the only sources for comprehensive understanding of the overall economic climate for business. Data source: Standard & Poors (www.standardandpoors.com). Unless otherwise stated, data is presented in Canadian dollars.