

# TerraFunds

Tax-Smart Investments

## To the Unitholders and Shareholders of

## Terra 2011 Flow-Through Limited Partnership and Terra Mutual Funds

We are pleased to present the December 31, 2011 quarterly update for the Terra 2011 Flow-Through LP ("Terra LP") and Terra Mutual Funds.

### Performance Overview

As of December 31, 2011, the unaudited net asset value of the Terra LP was \$65.24 (A class) and \$68.86 (F class), the Small Cap Fund was \$7.11 per share, Resource ETF Fund was \$6.52 per share, TerraTundra Equity Income Fund was \$10.19 per share and TerraTundra Money Market Fund was \$10.00 per share. See pages 3 through 7 for the portfolio holdings of each fund.

The fourth quarter proved to be another difficult quarter, as investors worried about the fallout from Europe's debt crisis which negatively impacted resource stocks.

For the quarter, the Small Cap Fund increased 0.85% and the ETF Fund declined 4.5%. For the quarter the TerraTundra Equity Income Fund increased 1.7% and the TerraTundra Money Market Fund remained unchanged. By way of comparison, the S&P/TSX Venture Composite Index increased 1.2% for the quarter. We underperformed the Index because we held a larger weighting in gold and copper stocks than the Index.

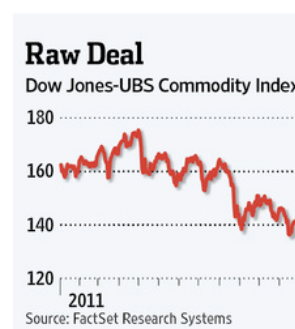
### Commentary

The year ended on a disappointing note, with junior, intermediate and senior resource companies suffering declines. Widespread concern over the European debt crisis and China's ability to manage slower growth increased concerns over a faltering world economy, which caused many investors to sell resource stocks.

Just how quickly events changed for commodity markets is captured in the performances for several resource indices. For example, the Dow Jones-UBS commodity index, after hitting its peak in April, suffered a 13% decline for the year - its first annual decline since 2008. Closer to home, the TSX Venture Exchange, on which junior exploration stocks trade, declined 35.1% in 2011.

So where do we go from here? There is an ongoing battle of opinions about which of two possible paths the commodities market will take. One view, is that the demand from China and other emerging nations will lead to a rise in commodity demand

and hence prices. The other view, is that the commodity prices are subject to further declines because the global economy is headed for a recession making further declines a possibility.



Although further declines may occur in the short-term there are many bargains to be had in the resource sector as evidenced by the pick-up in merger and acquisition activity. Despite the decline, commodity prices also remain above their 2010 lows, which we believe means a floor for resource

stocks has been established. Our view is the market is just too bearish and this extreme level of pessimism and disinterest is providing an opportunity to acquire resource firms and resource and commodity ETFs at substantially lower prices. At some point the market will take note of further monetary easing in the US and Europe and of the soft landing in China, causing resource stocks to jump in value.

### New Corporate Class Mutual Funds

During the quarter we introduced two new corporate class mutual funds: the TerraTundra Equity Income Fund and the TerraTundra Money Market Fund. The Equity Income Fund invests in a broadly diversified portfolio of 50 to 75 stocks comprising the S&P/TSX Equity Income Index - an index focused on dividend income. The Money Market Fund invests in short-term, high-quality securities with a maturity of less than one year. These new funds offer our investors the opportunity to diversify into non-resource investments on a tax-deferred basis.

### 2012 Flow-Through Offerings

If you are in need of flow-through for this year, please contact your advisor for more details as our 2012 Flow-Through LP offerings are now available.

Yours truly,  
John Jacobi,  
President, Terra Fund Management Ltd.

## Portfolio Managers' Comments

The fourth quarter of the year witnessed significant swings in the equity market as investors responded to the ebbs and flows coming out of the European financial crisis. The resource sector was particularly volatile, posting a strong rally in October followed by tax loss selling late in the quarter. Small cap resource stocks were particularly hard hit as a result of the tax loss selling. By quarter end the overall market, particularly resource stocks were very oversold.

We've held the view for some time that the economic weakness of the past year and a half has been associated with a mid-cycle growth slowdown. During the fourth quarter there were a number of indicators that began to suggest that the growth slowdown period was coming to an end. Private sector employment is growing again, capital spending has begun to improve and the ISM Purchasing Manager's New Orders Index has turned up. These indicators suggest that the economy is about to embark upon a sustainable recovery. This positive economic news has emerged at the point where investors are very cautious and therefore, will play an important role in shaping the equity markets in 2012.

Equities are positioned to outperform bonds in 2012. Corporate earnings are expected to grow again in 2012, though perhaps by a slower growth rate than in 2011. In spite of a pickup in the economy, we believe the corporate sector will spend more on employment and capital expenditures and as a result, profit margins may decline somewhat. We expect P/E multiples to increase in the next few months as investors begin to recognize the improving economic outlook.

China is expected to have a positive impact on global growth in the coming months as we expect them to successfully manage a soft landing in their economy. In early December, the Chinese began the first stage of easing monetary policy by reducing reserve requirements within their banking system. A renewed period of growth in China will have a direct and positive impact on the commodity markets. An expansionary monetary policy in China will reinforce the long-term structural trends to higher urbanization and expanding income per capita, which are two of the major drivers of strong commodity demand. The Canadian economy, therefore, will be a major beneficiary of an improvement in global economic growth

### Terra 2011 Flow-Through LP

The fund presently holds 53.4% gold and 43.5% energy, which includes 9.6% in uranium and 2.9% in metals. Given the extremely oversold conditions of the resource market, due to tax loss selling late in the year, we plan to hold our positions as

we expect a strong recovery in the resource stocks in the coming weeks.

### Terra Resource ETF Mutual Fund

At year end the fund continued to hold approximately 50% in flow-through securities. Given the extremely oversold condition of resource stocks due to tax loss selling, our strategy is to hold positions until we see a recovery in the markets, at which time we can reduce the positions in an orderly fashion. Proceeds from any sales of individual securities will be reinvested in resource ETF's.

The balance of the portfolio is made up of 10% cash, 15% energy ETF's, 13% metals and mining ETF's and 13% in a copper ETF. Our strategy going into the new year is to focus on investments in the energy and base metal area, as we believe the global economy will be surprisingly strong in 2012.

### Terra Small Cap Resource Mutual Fund

The fund presently holds 49% energy, 35.3% metals, 6.9% gold, 5.8% cash and 3.0% industrial. During the quarter we steadily built up our exposure in the energy sector as we believed this group has compelling valuations and attractive growth prospects. We also increased our weighting in the base metals sector particularly in the copper area. Both of these strategies were initiated to take advantage of the improving global economic environment. To fund these purchases we reduced our holdings in the gold sector, as gold stocks tend to peak from a seasonal stand point in December and January.

We believe the portfolio is well positioned to take advantage of the improving economic prospects in 2012. Our strategy continues to be to take advantage of the current downturn and selectively invest in undervalued firms.

### TerraTundra Equity Income Mutual Fund

Just before year end the fund received the rollover assets from the Terra 2011 Foundation Flow-Through LP. As a result, the fund assets are split between flow through holdings and dividend stocks which mirror the S&P/TSX Canadian Equity Income Index. As the flow-through securities become free trading they will be sold in an orderly manner and the funds reinvested in dividend paying securities. We have not written any covered calls against the portfolio as we believe the equity markets are positioned to perform well over the next few months.

### TerraTundra Money Market Mutual Fund

The fund is presently invested in Royal Bank of Canada short term notes maturing on February 1, 2012. The yield on these notes is 1.84%. We plan to reinvest the funds in bank paper with a very short maturity.

Yours truly, Marquest Asset Management