

# Third Quarter 2011

## Capital Markets Commentary

### Benchmark Returns for Periods ending September 30, 2011

| Index   | Quarter | 1 Year |
|---|---------|--------|
| DEX 91-Day T-Bill Index                       | 0.3     | 1.0    |
| DEX Universe Bond Index                       | 5.1     | 6.7    |
| S&P/TSX - Canadian Equities                   | -12.0   | -3.6   |
| S&P 500 - U.S. Equities (Cdn \$)              | -7.2    | 2.0    |
| MSCI World - World Equities (Cdn \$)          | -10.1   | -3.0   |
| Reuters CRB Index (CCI) - Commodities (US \$) | -11.8   | 4.0    |
| Canadian \$ Appreciation vs. U.S. \$          | -7.2    | -0.9   |

The third quarter's hair-raising market volatility ended with valuations and sentiment very low among investors, consumers and corporations worldwide. The gloomy mood could make the third quarter earnings season, which is now upon us, a rough one as investors search for clear signs of economic health. As more positive news on the U.S. economic and EU policymaking fronts flowed in October; global equity markets began to rebound from the cusp of bear market territory, recouping some of their painful losses of the third quarter. In fact off the lows of Oct 4<sup>th</sup>, returns had surpassed 10% as of this writing.

While recently released economic data on the U.S. employment and manufacturing front may have dispelled U.S. recession fears for now and a roadmap towards a "EuroTARP" recapitalization of the most "at-risk" European financials is in the works - this may be little comfort to investors suffering through the nerve wracking roller coaster ride that is the market this year. Many are now accustomed to believing that these market recoveries are short lived particularly in the wake of struggling economies and austerity programs despite historically low borrowing rates - so significant sums of both individual and

corporate money sits on the sidelines: conviction less. Unfortunately with the fundamental macro backdrop likely to remain challenging for the foreseeable future, we believe the "air pockets" in the market will persist.

The third quarter produced some of the worst equity returns since the financial collapse in 2008, with the S&P 500 Index down 14%, the S&P TSX Index down 12% with the European Bourses, the UK and the Hang Seng taking the biggest beatings falling 20-25%. Returns were far worse in certain sectors, as there was a dramatic leadership change away from the industrials, mining and energy sectors - all those that benefit from emerging market demand. Mining, within the S&P TSX, ended the quarter down 40% - lower Chinese commodity imports seem to be taking the "bubble" out of input prices. Chinese GDP growth slowed to 9.1% in Q3 down from 9.7% at the beginning of the year - still exemplary by any measure and the envy of the developed markets. The Chinese government's tightening efforts along with fragile consumer demand both in Europe and the U.S. are obviously taking hold.

Levels of stock market volatility increased to unprecedented highs and echoed the

2008 period, with triple-digit up and down days not an uncommon occurrence. For example, in the first week of August the markets experienced a tumultuous and bizarre week with the Dow Jones plummeting 635 points on Monday, soaring 430 points on Tuesday, falling 520 points on Wednesday only to climb 423 points on Thursday and add a further gain of 126 points on Friday! For all of this drama, the market lost 1.5% for the week.

My apologies for rehashing the pain of this quarter in such detail but my point is to illustrate just how difficult and skittish the current environment is. The “emotion induced” trading which produces these crazy swings is just that - emotion and it is the worst enemy of a successful fundamental investor. The stock market’s best known barometer of investor anxiety - the VIX (Chicago Board Options Exchange Volatility Index) - remained in the high 30s for most of the quarter, hitting a high of 48 in August. According to a report by JPMorgan Chase, “47% of 2906 funds the bank tracked have trailed their benchmarks by more than 2.5% this year, the highest proportion in 13 years”. To put it bluntly - equities had a brutal quarter.

The headwinds facing the equity markets intensified during the quarter but the debt drama in Europe seemed to be the primary culprit behind the extreme gyrations in market volatility in the first part of August- with “risk on” and “risk off” trades daily dependent upon the mood in Europe and the uncertainty about how severe the contagion could be. The market clearly recognizes the complexity involved in bringing 17 member countries to the table to devise a rescue plan for the enormous financial mess in Europe , let alone the task of seeing it through. However, the political gridlock in Washington and the subsequent

downgrade of the U.S. debt rating to AA, stubbornly high unemployment, an anaemic housing market and the broad-based slowdown in global economies all served to push many investors towards the doors.

With the market extremes of the past several weeks, bond yields traded to historic lows. Low yields could persist for some time as both Europe and the U.S. struggle to create jobs and growth. The U.S. Fed came out with a new policy strategy, “Operation Twist”, in which they sell a portion of their short term bond portfolio to purchase longer term bonds - 30% of which are in the 20-30year term. The idea behind this is to lower risk premiums and to spur investment - as liquidity is not the issue. Given the unprecedented flight to quality that we have witnessed in the bond markets we continue to believe that bonds are fundamentally overvalued.

While the current environment is eerily reminiscent of the market collapse in 2008, the situation is quite a bit different in many respects than it was then. The primary challenge today is neither a liquidity shortage nor corporate or consumer excess but government policy related to sovereign debt and emerging market inflation. These same issues are well known and have weighed heavily on stocks during the last year, and seem more than incorporated into asset prices. As a further contrast, in 2008 businesses were structured for peak operating levels. Companies were geared to expand and meet consumer demand supported by cheap and abundant debt. When credit contracted, the consumption decline was immediate and widespread. Today, companies have significantly less debt exposure. Although the global recession officially ended two years ago, slow recovery and caution have tempered

businesses' expansion plans for growth, as the U.S. unemployment numbers painfully indicate. Today, corporate profits are holding up well, cost structures are already sized to recession levels, inventories are lean, balance sheets are strong with almost all of them de-risked, the U.S. banking system is well-capitalized and free-cash flow and earnings yields are highly attractive on historic levels.

In this environment, we continue to invest in what we define as high-quality companies:

- those that are well-financed
- in defensible business that go on the offense in challenging times to further entrench their businesses
- partner with management teams who know how to manoeuvre successfully through business cycles and who will diligently work to prudently maximize shareholder value
- those that generate healthy cash flow and preferably have rising dividends (in fact, close to 50% of the U.S. holdings we have investments in have increased their dividends year to date)

We as investors continue to:

- Have a long-term investment horizon for owning quality companies through economic cycles.
- Use conservative assumptions in our research and business valuation models.
- Pay what we believe is a sufficient discount to our assessment of a company's valuation in order to provide downside protection against the impact of exogenous events.

While we do have full confidence in the companies we hold, we have absolutely no ability to predict or navigate the stock market in the short-term or what investors are willing to pay for our companies. Unfortunately, we do live in a world where short-term thinking dominates and it seems the noise is louder than ever. We continue to believe that quality will prevail and we will use the irrational volatility to take advantage of good investing opportunities.



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