



INVESTMENT REVIEW AND ECONOMIC OUTLOOK

Second Quarter 2008

Overview

During the second quarter of 2008, global equity markets experienced further deterioration as oil prices climbed from \$100 per barrel to the quarter-end record high of \$142 per barrel. Investors feared that higher oil prices, coupled with the continuing saga of deteriorating housing prices, poor consumer confidence and a U.S. Federal Reserve that appears to be wavering on interest rate policy would cause economic growth to slow considerably. Europe, too, experienced a decline as the Central Bank has signaled its intention to fight inflation concerns at the same time the economic growth picture appears to be slowing. We believe that the U.S. economy has entered a protracted period of slower economic growth, while Europe will remain in better shape. The S&P 500 Index posted a drop of almost 3.6% during the quarter and is now down over 9.2% on a year-to-date basis. On the EAFE side of the equation, the Morgan Stanley EAFE Index was down over 2.8% in the quarter and is now down 7.8% on a year-to-date basis.

The Canadian equity market rose a very respectable 9.1% during the second quarter; largely as a result of the hefty 30% TSX Composite Index weight in the Energy sector. Energy wasn't the only driver however, as bulk commodities like iron ore, coal and fertilizer prices also skyrocketed due to a very tight global supply/demand picture for those materials. The Canadian dollar ended the quarter trading slightly below par to the U.S. dollar.

Investors bid stocks higher early in the quarter, choosing to look past the current period of economic malaise and instead focused on the expected recovery later in the year. However, early gains were erased in the second half as concerns resurfaced over continued deterioration in the housing and labour markets. Fixed income markets were also weak as yields increased on worries that spiraling commodity prices would fuel higher inflation.

Canada

Many economists believe that “when the U.S. sneezes, Canada catches a cold” implying that Canada will be very much negatively affected by the slowdown in the U.S. After a solid 2.7% real GDP growth rate in 2007, the Canadian economy is clearly slowing, increasing a meager 1.2% on a year-over-year basis in April. Unlike in the U.S., consumption remains fairly strong, however, Canadian growth is being negatively impacted by the strong loonie, as the export sector is now experiencing negative growth. Outside of manufacturing, this has not yet impacted the job market in a major way, as the Canadian unemployment rate remains near 6%, with 130,000 new jobs being created year-to-date.

The Canadian resource juggernaut continues on - \$140 oil, \$13 natural gas, \$400 copper and \$950 gold bullion have led the S&P/TSX to be the strongest major global bourse in 2008. The resource phenomenon has also allowed Canada to escape the dramatic economic



INVESTMENT REVIEW AND ECONOMIC OUTLOOK (CONT'D)

slowdown seen in the U.S., as western Canadian job growth has more than made up for eastern Canadian job weakness. In effect, Canada has become the world's resource provider. This has led to several imbalances however. While the overall Canadian Consumer Price Index remains fairly benign with a yearly increase of only 2.2% year-over-year in May, western Canadian inflation is very real, in everything from labour to housing. Alberta's increase in CPI year-over-year in May was a very substantial 3.7%. With regard to the housing market, the western boom is beginning to show signs of cracking. After rising substantially over the last 7 years, home prices in the west are now dropping, with both Calgary and Edmonton home prices 5% lower than one year ago.

Ontario and Quebec are essentially in a manufacturing recession – 2008 GDP growth for both provinces is estimated to be less than 0.5%. Unemployment is significantly above the national average, with Ontario at 6.6% and Quebec at a staggering 7.2% in May. Contrast these abysmal statistics with those of Alberta and Saskatchewan – Alberta will likely generate close to 3.5% GDP growth in 2008 while Saskatchewan's thriving agriculture and potash industries will allow that province to ring in over 4% in GDP growth. As well, Alberta's unemployment rate remains anchored at 3.6%, while Saskatchewan continues to fall, to just 4.1% in May.

While the high price of commodities and the high Canadian dollar are mostly responsible for these regional economic performances, the weak U.S. economy is also a major contributor. Ontario and Quebec continue to depend heavily on manufacturing exports to the United States, with auto products in particular remaining an important area. The auto market in the U.S. is almost in depression-like territory. Domestic auto sales in the U.S. have fallen to barely 10 million per annum. This is down to levels not seen since the late 1980's and substantially lower than the 15-16 million cars sold per annum just a few years ago.

Our view is that the Canadian economy will continue to slow – western Canadian strength will simply not be enough to overcome the weakness in Ontario and Quebec. The Canadian consumer will retrench as well, although not to the degree that will be seen in the U.S. As a result, we believe Canadian GDP growth will outperform that of the U.S. this year, and will increase 1 – 1.5%. The Bank of Canada will likely continue to try and be sensitive to the needs of both eastern and western Canada, as they balance inflation in western Canada with the slowdown in the east. As a result, we believe the Bank will likely sit on the sidelines for the balance of 2008 and maintain the Bank Rate at 3%.

Financials and Energy names dominated the top ten holdings this quarter. Energy (+22.9%), Materials (+17.6%) and Utilities (+6.5%) sectors led the overall S&P/TSX. Four of the top five portfolio performers were from the Energy and Materials sectors which benefitted from higher energy and agricultural commodity prices. Agrium (+72.4%), was up strongly this quarter after the company reported earnings which significantly exceeded analysts' consensus estimates. Bombardier (+35.5%) moved higher after the company reported stronger than expected Q1/Fiscal 2009 revenues and earnings. Healthcare (-10.9%), Consumer Discretionary (-10.7%) and Financials (-3.3%) sectors were the performance laggards in the S&P/TSX this quarter. The five bottom performers were from four different sectors; Consumer Discretionary, Industrials, Materials and Financials. Canadian Tire (-20.2%) was weak after the company reported Q108 EPS that was below consensus estimates as same store sales were down 4% compared to last quarter. Finning (-12.3%) was lower after the company reported Q108 earnings results that were below analysts' consensus estimates mainly due to the strength of the Canadian dollar and a higher proportion of lower margin new equipment sales.



INVESTMENT REVIEW AND ECONOMIC OUTLOOK (CONT'D)

Debt Markets

We wrote in the last edition of the Investment Outlook that while all of the Federal Reserve actions engaged during late 2007 and early 2008 were very positive, none was a “silver bullet”. They certainly would help re-liquefy the banking system and prevent a multi-year Japanese-style deflation. But many of the “Main Street” problems still remained – a housing recession and a deteriorating labour market being the most serious. Yet, the bailout of Bear Stearns in mid March proved to be a seminal event, as markets interpreted this action as the Fed saving the entire banking system from complete meltdown. Not only did equity markets rally, but so did global credit markets as investors began once again buying risk. After having widened out as much as 150 basis points since May 2007, high-grade corporate bond spreads tightened 50 basis points. High-yield bonds performed even better, tightening in 200 basis points, after widening an astounding 600 basis points from May 2007. As we mentioned last quarter, there was little value in government bonds – yields had dropped to very unattractive levels. After the Bear Stearns news, government bond yields moved substantially higher, as investors sold treasuries to return to riskier assets.

The Fed added to the mix in May, as higher food and energy inflation led it to change its rhetoric to be much more hawkish – the market’s interpretation was that the next Fed rate move might even be higher. The bellwether 10-year U.S. Treasury bond yield moved to well above 4% in May as a result.

Late in the quarter several banks took still further write downs and the deterioration in both the housing and labour markets accelerated. Government bond yields stabilized and even rallied somewhat and credit and equity markets gave back some of their earlier gains. As a result, the DEX Universe Bond Index had a negative return of 0.7% in the quarter, for a year-to-date return of 2.2%. The corporate bond market stabilized late in the second quarter, and modestly outperformed the Government of Canada market.

With the recent sell-off in government bond yields over the last month, value has improved somewhat and given our view that the global financial workout will continue for another couple of quarters and that North American economies are slowing sharply, we are still slightly bullish on the Canadian bond market.

As this workout continues into 2008, credit markets will continue to be very volatile – default rates will likely rise and liquidity will continue to be challenging. However, there continues to be excellent value in the credit markets, both in high-yield and particularly in investment-grade corporates, where credit spreads are as attractive as they have been in almost twenty years and where historical default rates are at less than 1%.

Given our view that economies are slowing sharply and the global financial system will continue to be under stress, we believe the bias for interest rates is stable or slightly lower, and value in the bond market is attractive. Thus, we are maintaining portfolio duration modestly longer than that of the market. We are also in the process of adding substantially to the corporate bond component of the fixed income portfolio and will continue to do so over the next few quarters.

United States

The U.S. economy is clearly slowing to a virtual crawl, plagued by a continuing housing recession, a banking system that was in full crisis mode in the first quarter, a credit crunch

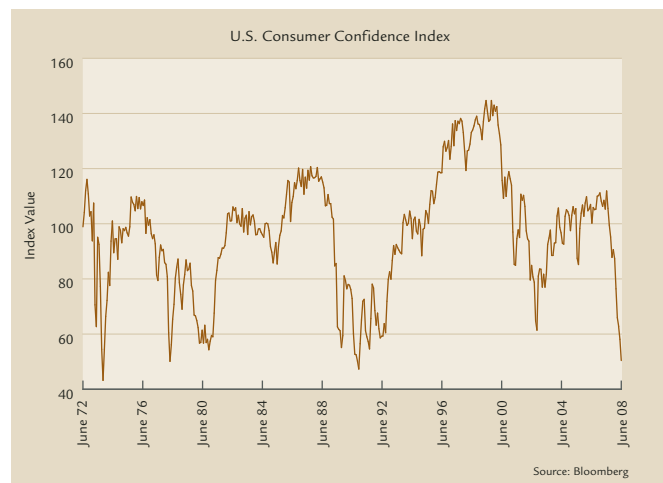
INVESTMENT REVIEW AND ECONOMIC OUTLOOK (CONT'D)

and the rising price of gasoline and food. Real GDP for the first quarter increased a paltry 0.6% on a year-over-year basis, not quite into negative territory yet, but certainly very weak. The second half promises to be more of the same, as a \$106 billion federal tax cut was used mainly by the U.S. consumer to reduce their household debt, rather than to spend.

Residential construction continues to be negative and business capital investment is slowing sharply. As well, write downs in the financial sector do not appear to be over yet. The good news is that the Federal Reserve cut its administered rate by a further 25 basis points in the second quarter, to 2%, for cumulative rate cuts of 325 basis points since last Fall.

The confidence of the U.S. consumer began to drop last July – this trend shows no signs of abating, as confidence indicators are at levels not seen since the recession of 1990-91. In fact, consumer confidence is at a lower level than the crises of the 1987 stock market crash, the 1991 Iraq war, the 1997 Asian Flu, the 1998 Russian Default and Long Term Capital Management crisis, the 2001 Tech Wreck and 9/11. The perennially optimistic U.S. consumer appears tired – retail sales are still positive, rising 2.5% year-over-year in May, but this is down from the 5% yearly increase one year ago. \$4 per gallon gasoline and a decline in home equity continue to be big contributors. House prices were down 15% year-over-year in April. This does not appear to be stabilizing, as housing inventories remain at generational highs.

More important than those factors however, is the labour market. We have always maintained that consumers would continue to spend as long as they had employment. After almost five consecutive years of monthly job growth, the employment market turned south in January. This negative trend has continued in each of the first six months of 2008, bringing cumulative job losses to 438,000 through the end of June and increasing the unemployment rate to 5.5%. Since the recession of 1991, U.S. personal consumption has recorded 65 consecutive quarters of positive growth. If this negative job market trend continues, it may be very difficult for this remarkable consumption growth to continue.





INVESTMENT REVIEW AND ECONOMIC OUTLOOK (CONT'D)

Earlier this quarter, the line “Inflation’s Back” was on the cover of an issue of *The Economist*. Yes, clearly with \$140 oil and the price of food rising the world over, inflation is on the mind of many consumers. Yet, is it going to be as big an issue as many think? Perhaps not. It is true that headline CPI in the U.S. is now rising at a 4.2% rate, up significantly from the rate one year ago. However, core CPI is rising at a still modest 2.3% year-over-year rate. While energy is up a huge 17% and food is rising at a 5% rate, these two components represent only 25% of the CPI basket. Price increases in most of the other components are relatively benign and in fact, some components such as clothing and any housing related items are actually in deflation mode. While the inflated price of energy may filter through the rest of the CPI complex, it has not done so to date.

The most important reason that inflation may be less of a factor than many think is wages. At least up until now, there just simply has not been any wage inflation. In fact, wage growth is decelerating. The Unit Labor Cost Index increased a paltry 0.7% year-over-year in March, versus its 4.3% increase one year ago. Furthermore, labour productivity is actually rising once again, up 3.3% on a yearly basis versus just a 1% rate in June 2007. It does not appear that the work force has much bargaining power and with continued job losses, this may not change. Many strategists are equating inflation in 2008 with inflation in the 1970’s. But in the 1970’s it was not just commodities that were rising – everything was rising and fast. And that included wages. Until there is evidence of this, the inflation scare may be contained to only energy and food.

Our view is that the labour market will continue to deteriorate. Combined with the housing recession and the high price of gasoline, we believe this will lead to very stagnant consumer spending over the next couple of quarters. As a result, our estimate for 2008 U.S. real GDP growth is 0 – 1%. While headline inflation may continue to rise into the second half of the year, we believe that core inflation will remain muted. The Federal Reserve will continue to maintain the view that the balance of risk lies in a slowing economy rather than an increase in inflation. Thus, it is our view that the Fed funds rate remains at or near 2% for the balance of the year.

From an investment perspective the quarter started off on the right track (with the S&P 500 rallying 7% from the beginning of the quarter and up 12% from the lows of the year set on March 17th to the end of May), the same issues that jolted the markets in the first quarter returned to the forefront – a continuing (and deepening) housing recession, a banking system in full crisis mode, a credit crunch exacerbated by the siphoning out of excess leverage in the system, and the tighter strain placed on already stretched consumer balance sheets from the rising price of gasoline and food. The end result was the return of elevated volatility levels and a sharp sell-off in the last few weeks of the quarter leading to a 3.6% decline in the S&P 500 (in C\$) for the period.

Consumer Staples, Industrial and Healthcare names dominated the top ten holdings this quarter. Energy (+16.3%), Utilities (+7.0%) and Materials (+3.5%) were the best performing sectors over the past quarter in the S&P 500 Index. The top five performers were from the Financials, Energy, Technology and Healthcare sectors. Eaton Vance (+29.3%) was up strongly after the company delivered a positive fiscal Q208 earnings report that showed one of the strongest organic growth rates, even as the closed end fund market remained shut. Financials (-19.1%), Industrials (-10.9%) and Consumer Discretionary (-8.6%) were the worst performing sectors for the quarter. The bottom five performers were from the Financials, Industrials, Healthcare and Consumer Discretionary sectors. Bank of America



INVESTMENT REVIEW AND ECONOMIC OUTLOOK (CONT'D)

(-37.5%), was the worst performing name for the quarter as mounting recession, inflation and credit quality concerns continue to weigh heavily on the banking sector. Most of the write-downs and credit losses so far have been related to residential real estate. However, markets are now concerned that credit deterioration will spread to the commercial and auto areas of the market.

Global

International equity markets were broadly weaker during the second quarter of 2008. The Morgan Stanley EAFE, European and Asia Pacific indices returned -2.8%, -4.6% and 1.3% respectively (Canadian dollar returns). Inflationary pressures have intensified globally, driven primarily by energy and food costs. At the same time, expectations for economic growth have been revised downwards. Central bankers for the most part are responding by implementing tighter monetary policies, taking the view that the prospect of inflation spiraling out of control is an unacceptable risk. The risk of course is that economic growth suffers to a greater extent than anticipated. The effectiveness of monetary policy in combating energy and food price inflation which have emanated from developing countries will be tested through the coming year. Meanwhile, consumers globally have come under considerable stress as a result of higher energy and food prices, softening property prices, weaker equity markets and tighter credit conditions. Food and energy price pressures have the greatest impact on consumers in developing nations where these items comprise a much larger portion of household budgets.

The single-minded focus of the European Central Bank (ECB) on inflation was brought into focus this past month. Consumer price inflation reached a level of 4% in June, 2% above the upper limits that the ECB is comfortable with. Producer price inflation rose to a level of 7.1% in May from 6.2% in April. These developments were accompanied by broad deterioration in the service and manufacturing sectors as well as business and consumer confidence. However, the ECB opted to raise rates by 25 basis points to 4.25% in July citing concerns over inflationary pressures. The ECB is clearly concerned that elevated levels of inflation might become embedded in the market's expectations. The U.K. economy exhibited further signs of weakness. The service sector actually contracted in June, consumer confidence registered the lowest reading since 1990 and GDP grew at a tepid rate of 0.3% in the first quarter. The housing market is experiencing a dramatic downturn and retail spending has fallen sharply.

Asia has also started to show the effects of a slowing global economy. In Japan, the Tankan survey indicated weakening business conditions and the weakest level of manufacturing company sentiment in the last four years. Household spending and employment data also registered weaker trends. Core CPI rose 1.5% in May and some observers suggest that emerging inflation, after a prolonged deflationary environment, may stimulate consumer spending. Considering the headwinds that consumers face and the weak outlook for employment and the global economy, we would not expect a surge in consumer spending. Inflation has become a major concern in a number of Asian countries and central banks have responded with recent rate hikes in Taiwan, India, Indonesia and the Philippines. China has continued to increase banking reserve requirements which may now start to slow lending. While some signs of slower growth are emerging in China, the economy remains strong with consumption growing 22% in May and exports increasing 28%.



INVESTMENT REVIEW AND ECONOMIC OUTLOOK (CONT'D)

Emerging markets remained under pressure as inflation continued to surge and investors reassessed countries' growth prospects and valuations in light of imminent interest rate hikes. One of the hardest hit was Vietnam with its stock market devalued by 50% as inflation reached over 20%. Major country indices also tumbled, most notably China and India which are now down 50% and 35%, respectively from their peaks. The banking crisis continues to spread beyond U.S. borders, putting severe strains on levered institutions. Countries with sizeable current account deficits, such as Turkey, remained under stress as investors question their ability to meet their funding requirements in such a difficult environment. The standout performers remained energy and material names as the underlying commodities continued to increase, most notably oil and coal. Our strategy is to continue to focus on solid business models delivering quality profits that are insulated from the U.S. led financial crisis and that are geared to strong domestic trends.

The Private International Equity Fund outperformed its relevant benchmark by 264 basis points during the second quarter. On a segmented basis, strong relative performance within European and Emerging Markets more than offset weaker returns in Asia Pacific. Throughout the portfolio a relatively cautious stance toward the financial services sector was beneficial with Man Group, Sumitomo Mitsubishi Financial and Hutchison Whampoa outperforming. In the materials sector, Arcelor Mittal, CVRD, Israel Chemical and Yara contributed to outperformance. Weak returns from France Telecom, Globe Telecom and Turkcell negatively affected results in the telecom sector. Investment returns have continued the strong pattern of superior performance achieved through the past four years.

Forecast

The consensus view is that the current North American economic downturn will be followed by a recovery later this year or early next. As well, a recovery abroad is also expected as foreign currencies weaken and financial conditions stabilize. We continue to believe that the U.S. economy will slow but will likely avoid a deep and prolonged recession as the healthy non-financial areas of the economy provides some offset to the weakness within the housing and banking related sectors. Similarly, we believe that the Canadian economy will also slow this year, but given the strong commodity pricing environment the Canadian economy will likely weather the current downturn better than the U.S.

From an investment perspective we currently see a market of extremes. At one end, we have financial and consumer spending levered stocks where fundamentals are/will continue to deteriorate. At the other extreme, we have the materials and energy complex, where inflation of commodity prices has driven a multi-year bull run. In between these two extremes (encompassing industrials, technology, healthcare and consumer staples), we believe there is confusion in the market. These sectors have followed financials and discretionary stocks down given the fear the credit cycle will spread to a business cycle and also that higher input costs will impact profitability. This confusion, we believe, will create opportunities over the long-term for fundamental bottom-up stock selection.