

INVESTMENT REVIEW AND ECONOMIC OUTLOOK

Second Quarter 2009

Overview

World equity markets began to rally at the end of the first quarter and continued to post strong gains in the second quarter. The MSCI World Index was up 11.7% for the three months ended June 30, the S&P 500 Index rose 6.9% (both in Canadian dollars) and the S&P/TSX Composite Index added 20.0%. It was a remarkable change from the losses posted in the previous two quarters. Although most global stock markets were positive in the second quarter, it was the more risky asset classes that produced the highest returns. In Canadian dollars, the MSCI Emerging Markets Index was up 24.4%, and the MSCI EAFE Index rose 16.1%, while Canada's Nesbitt Burns Small Cap Index gained 25.8%. In the Canadian fixed-income market, strength was seen in the DEX Corporate Bond Index, up 6.5%. The DEX Universe Bond Index generated a return of 1.3%, with the DEX Canada Bond Index off by 1.8%.

Clearly, investors in the April to June period became more confident. During the March market lows, overly pessimistic investors were pricing in an economic environment similar to that of the Great Depression. The market rally that followed, we believe, is a function of investment assets simply having become too cheap, particularly in yield-related financial instruments, and reflects investors' shift to a more realistic and less negative view of the global economy. Indeed, the surprise to us during the quarter was not the state and/or the direction of the global economy, but rather the magnitude of the market rally and how quickly investors' attitudes changed. They had driven the price of equities way too low on overdone fears, and corporate bonds, on a risk-adjusted basis, offered exceptional investment opportunities. Now, with higher equity markets and a significant narrowing of corporate bond spreads versus treasuries, we have somewhat tamed our optimistic view. Valuations are approaching normalcy, and more accurately reflect a strained global economy facing substantial challenges. Although the markets are now not expensive, we do not expect the same explosive upward move as recently seen. We continue to believe that the economy will rebound starting late this year at the earliest, but more likely in 2010.

There is reason for optimism... even though the recovery will take time

We are mindful that the U.S. has lost an astonishing 6.46 million jobs in the last 18 months. The Canadian economy has fared better, with 207,000 jobs disappearing. Although Canada's job loss figure sounds better, we do note that our economy entered the recession much later than the U.S. and 286,000 jobs have been lost in the last six months. Obviously, governments are doing what they can to stimulate the economy and add jobs; however, recovery will take time as anxious consumers are not spending. The recovery is likely to be anemic by historical standards and will not be led by consumers this time. Recouping job losses, especially in the U.S., could take until the middle of the next decade. Although the global economy remains fragile and markets are volatile, we believe that the worst is over. Encouraging signs continue to point to a strengthening economy that will lead to a sustainable improvement in capital markets. What are some of these signposts?

- Global capital markets are functioning again. Over the past quarter, through the issuance of corporate debt and equity, many companies have begun to repair or have repaired their balance sheets. This has been particularly true for banks and other financial institutions, which were at the centre of the crisis.
 - Aggressive fiscal and monetary policy initiatives are calming capital markets and providing stimulus to global economies. It is evident that failure is not an option. Most governments continue to deploy massive resources to prompt economic activity.
 - Recent economic data continues to improve. Even the U.S. housing market is showing some improvement, particularly in actual sales and the inventory of unsold homes.
 - Record amounts of cash continue to sit on the sidelines generating little or no return. As confidence continues to build, we expect that some of this cash will eventually find its way into equities and higher yielding fixed-income instruments.
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For the remainder of 2009, we anticipate equity markets will remain volatile and make minimal progress from current levels. Some of the extreme under-valuations in the market have been corrected. Earnings growth is required in order to propel equities further, and we may see some of that in the third quarter, although we anticipate most companies will only demonstrate better earnings comparisons in the fourth quarter or the first quarter of 2010. In the fixed-income asset class, corporate bond spreads over the past two quarters have narrowed to the point that although current valuations are still inexpensive, the expected return is the coupon, with limited expectations for capital appreciation.

KBSH portfolios had strong performance in second quarter

The KBSH Private Bond Fund, with its high exposure to corporate bonds, performed exceptionally well. Credit finally paid off. Corporate spreads still look reasonably valued when compared to historical figures. However, late in the second quarter, we started to reduce our substantial overweight position in corporates. Going forward, we expect to be modestly overweight at these spreads and may repurchase some of our second-quarter sales if spreads widen.

The KBSH Private Global Value Fund also performed very well this quarter, while the KBSH Private Canadian Equity Fund generated returns comparable to the market. We began the quarter with a constructive view of the market, but were surprised with the magnitude of the upward move, particularly in equities, in light of the economic backdrop.

In Canada, our holdings in the energy and financials sectors were strong contributors to overall performance. Financials, in particular, performed well, with Toronto-Dominion Bank and the Bank of Nova Scotia both up in excess of 40%. The rebound in bank equities is partly a reflection of the inherent strength of the Canadian banking system, and the fact that in this tough economic environment banks have continued to strengthen their balance sheets. When oil was trading in the high US\$30 a barrel range, we felt strongly that these prices were not justifiable, given that most global oil companies had not been able to replenish their reserves. Although global demand had been temporarily curtailed, this was a short-term phenomenon and not likely to be sustained. Three months later, oil was back to \$70 and oil equities have rallied in a like fashion. The underperformance of our Canadian equities was concentrated in the materials sector, namely in gold issues. We have made minimal changes to the portfolios, believing that companies such as SNC-Lavalin, Research In Motion and Shoppers Drug Mart are still attractive investments.

Globally, a large allocation to the financials sector contributed significantly to the strong performance exhibited in our portfolios. Bank of America and Wells Fargo, two large U.S. bank holdings, both returned over 70% for the quarter, while Lincoln National and Principal Financial were up in excess of 100%.

The KBSH Private Balanced Fund is positioned with 60% equities and 40% in fixed-income and cash equivalents, in line with its benchmark. We anticipate that in the third quarter, we will gradually increase the portfolio's exposure to equities.

All of our portfolios, equities and bonds alike, are well positioned to take advantage of an improving economy. We continue to invest with conviction in high-quality franchise companies with earnings growth which is superior to that of the market, and at valuations that are justifiable. This is consistent with our investment philosophy.

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