



INVESTMENT REVIEW AND ECONOMIC OUTLOOK

Third Quarter 2008

Overview

The third quarter of 2008 witnessed some of the most dramatic events in global capital markets in the last fifty years, as the global credit crunch intensified. What caused all this? A toxic confluence of several factors – the bursting of one of the greatest housing bubbles ever, far too much leverage at both the consumer and financial institution level, too much liquidity and lastly, the meteoric growth of the credit derivative and collateralized debt obligation (CDO) market. The financial fallout has been truly unbelievable: 1) the arranged bailout of Bear Stearns, 2) the quasi-nationalization of housing authorities Fannie Mae and Freddie Mac, 3) the seizure of Washington Mutual, 4) the Chapter 11 filing of Lehman Brothers, 5) the takeover of Merrill Lynch by Bank of America, 6) the conversion of both Morgan Stanley and Goldman Sachs from pure investment bank to regulated commercial bank. Even more alarming has been the almost complete freeze-up of global credit and bank lending markets, and now the transfer of all of these difficulties from the financial market into the real economy. Consumers are beginning to retrench, and the labour market is deteriorating rapidly.

We believe that both the global financial system and economy will in fact survive, and avoid the type of economic calamity witnessed during the Great Depression and also the Lost Decade of the 1990's in Japan. However, markets will continue to be very volatile, and the economies will flirt with recessionary conditions. One of the conditions for the U.S. economy to stabilize and begin growing again is for the housing market to stabilize, which we have not yet seen. It is likely that a further 10-15% drop in home prices will be needed to get the housing market back into balance. We mentioned that the labour market is deteriorating, with a cumulative 760,000 jobs lost year to date. This will get worse before it gets better, as companies lay off workers. Further evidence that this is coming is that the Institute of Supply Management Purchasing Managers' Index, a broad gauge of industrial activity in the U.S., has dropped to well below 50, a sign of economic contraction. Consumer spending will thus drop considerably in the upcoming quarters and GDP growth in the last quarter of 2008 and the first quarter of 2009 will be very close to registering a negative number. Real GDP growth for 2008 will likely be just over 1%, while 2009 will be closer to 0%.

While the economy will get worse before it gets better, the good news is that the U.S. economy does have an excellent track record of repairing itself when it is ill, and we believe this will occur again. The successful passage of the TARP (Troubled Asset Recovery Plan) is the first step toward a healing of credit markets and of the economy, and while it will take some time, we believe the patient will in fact, survive, and will slowly heal.



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Canada

The banking and financial system in Canada has experienced its fair share of pain over the last few months – write downs, weaker earnings and layoffs are certainly prevalent in this country as they are globally. However, the conservative nature of both the Canadian banking system and also the Canadian consumer is now truly showing its benefit as this country to date has avoided any major financial bankruptcies or restructurings. Canadian banks have always had a more conservative business mix than their US counterparts – all six big Canadian banks have a very large portion of their asset base in large and established retail franchises, with very stable deposit bases. This has proven to be an extremely valuable source of funds when raising money in the capital markets is so difficult. In fact, as mentioned earlier, both Goldman Sachs and Morgan Stanley are altering their business model to be more commercial bank in nature and more like the Canadian model. Also, the banks here generally have more conservative balance sheets with less leverage and the Canadian bank customer is simply much more conservative than his U.S. counterpart. America has always been known as a consumer nation, and this mantra has certainly intensified over the last few years, as their household savings rate has moved into negative territory. Canada meanwhile has historically been known as a nation of savers – the ratio of household debt to income is far lower in Canada than it is in the United States and furthermore, Americans in this last cycle used 30% more debt than Canadians to purchase homes and household assets. This Canadian “save for a rainy day” mentality is now providing tremendous dividends.

The Canadian economy, however, will not be completely immune from the U.S. and global slow down. While GDP growth surprised to the upside at 0.7% in the month of July, this number was pushed up by exceptional spending in the mining space, which is now being curtailed due to falling commodity prices. The all-important export sector is ill, due to a combination of high commodity prices, a slowing U.S. economy and a high Canadian dollar – in the second quarter, exports dropped 6.8% on a yearly basis. The Canadian consumer is becoming more frugal – in July, year-over-year discretionary purchases were up a very meager 0.1%. Housing is softening as well, with the average home price down 5% year-over-year on a national basis in July. And perhaps most importantly, the Canadian job creation juggernaut has turned negative, with 55,000 jobs lost in July and the unemployment rate increasing to 6.4%. Clearly, when the U.S. sneezes, Canada does catch a cold.

The economy will continue to slow, however it may escape outright recession. With U.S. consumer spending moving close to negative territory combined with a Canadian dollar at parity, the Canadian export sector will continue to be a tremendous drag on GDP growth for the balance of 2008 and into 2009. As mentioned, the Canadian consumer is less levered than his U.S. counterpart and his home equity is not nearly as impaired; thus, Canadian consumer spending will likely slow, but not to the same degree as in the U.S. Job losses will continue to move higher, particularly in the export-centric central Canadian provinces.

Canadian real GDP growth for 2008 will likely be around 1%, while 2009 will improve to 1.5%. Like in the U.S., inflation will not be a problem near term and thus Bank of Canada will likely maintain a downward bias in rates, to guard against further economic weakness.



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Financials and Energy names dominated the top ten holdings in the Canadian portfolio this quarter. Financials (+2.6%), Consumer Discretionary (-3.8%) and Consumer Staples (-4.6%) sectors led the overall S&P/TSX this quarter. Four of the top five portfolio performers were from the Financials and Consumer Discretionary sectors. Technology (-38.0%), Materials (-33.6%) and Energy (-27.0%) sectors were the performance laggards in the S&P/TSX this quarter. The bottom performers were diversified amongst these three sectors.

With the recent selloff in the Canadian markets we are finding real values and investment opportunities. Our investment approach has always been bottom up, trying to identify quality franchise companies selling at reasonable, and in some cases now, distressed valuations. We are very confident that our portfolios are structured to weather the current uncertain economic environment and will continue to outperform the market over the longer term. We continue to remain underweight the Financial Service industry and the Consumer Discretionary areas of the market. Our portfolio focus continues to be on Technology, Healthcare and Energy companies.

Debt Markets

The third quarter of 2008 was highlighted by a very significant steepening of the yield curve in both Canada and the United States. U.S. 3-month treasury bills dropped down toward 0.5% in the third quarter even going negative on one of the most fearful days in late September! Essentially what this means is that investors were paying the U.S. government to take their money – this was seen in Japan in the mid 1990's during the middle of their economic malaise.

The DEX Universe Bond Index had a negative return of 0.4% in the quarter, for a year-to-date return of 1.8%. With the credit crunch continuing, the corporate bond market underperformed the Government of Canada bond market in the quarter.

The bond market continued to be the epicenter of this global market downturn, as the credit crunch showed no signs of abating in the quarter. The senior market was very much a tale of markets, with investors flocking to government bonds and exiting credit markets. The bellwether 10-year U.S. Treasury bond yield moved back down below 4% to 3.80% in the quarter, as the market's preoccupation with inflation was overwhelmed by one of financial and economic weakness. This is a huge change from June of this year, when yields rose significantly due to inflation concern. We never really believed in the inflation story for two reasons: 1) inflation was confined to two sectors, food and energy, with no inflation in the biggest component of the inflation complex, wages, 2) the U.S. financial and economic system was simply too precarious for rate hikes to be at all on the table. Thus, our view was that rates would move lower, not higher, and this was borne out in the quarter.

Fear was most evident in the bank market and the corporate bond markets - in late September, banks globally became extremely fearful of lending to one another. This was exemplified by the spike in the London Interbank Offering rate (LIBOR), which is the rate at which banks lend to one another on a daily basis. 3-month LIBOR rose to 4.25% in September, up from 2% earlier in the third quarter. Perhaps even more telling is the TED spread, which is LIBOR less 3-month U.S. Treasuries – this spread captures the perceived risk that banks have of lending to one another versus the U.S. government. This spread rocketed to well over 200 basis points by September end.



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While risk has certainly been elevated in all credit markets and there will be continued volatility, we believe that many of the conditions for eventual stability have now been put into place, with the U.S. treasury stabilization package, and with consolidation in the financial sector rapidly occurring. There will of course be winners and losers in this space, and this will provide investors with the opportunity to add the paper of high-quality institutions at the most attractive spreads seen in several generations.

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 not unattractive. Thus, we are maintaining a portfolio duration modestly longer than that of the market.

With credit spreads at generational wide levels, we continue 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. While spreads may continue to be volatile over the next few quarters, we believe the allocation to corporate bonds will add significant value over the next few quarters and years.

United States

Unlike in Japan in the early 1990's, the U.S. Treasury and Federal Reserve have been quick to respond to this crisis. The Fed has added liquidity to the system by cutting its administered rate to 2%, a cumulative cut of 325 basis points. It has also dramatically increased its available bank lending windows and purchased riskier assets from failing banks – the percentage of Treasuries on the Fed's balance sheet has dropped from 93% in July 2007 to just 54% today. The Treasury has been even more active, by essentially nationalizing the two housing authorities, and facilitating the takeovers of some of the above institutions, in its attempt to prevent the entire financial system from seizing up.

Most importantly however, the Treasury has instituted the TARP, which after much debate the two houses of government approved. This is a giant \$750 billion program to essentially buy up impaired mortgages and mortgage securities from banks – the basic thesis is that this action will put a bid into the market for these instruments, stabilize the market, and allow banks to lend once again and facilitate credit creation. The other major component of the Treasury's package includes an increase in bank deposit insurance under the Federal Deposit Insurance Corporation, from \$100,000 to \$250,000, to protect homeowners. We believe that both components are necessary conditions to get the system moving again. When we look at the major financial crises throughout history, it is very apparent that markets cannot fix themselves in these extreme instances – a major government package was necessary to stabilize the system. This was true in the Savings & Loan Crisis of the late 1980's, with the Resolution Trust Corporation, and also during the Great Depression of the 1930's, with the Federal Reconstruction Finance Corporation.

After a brief respite in selling pressure at the mid-point of the second quarter, S&P performance in the third quarter continued where the second quarter left off...under intense selling pressures. In our view, the issues that jolted the markets in the first half of the year - 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 - have been discounted by the market to a significant degree. That said, a spike in fear levels related



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to financial shocks (Fannie and Freddie conservatorships, Lehman bankruptcy, bailouts or forced sales of Washington Mutual, Wachovia and AIG) coupled with forced selling as leverage continues to be squeezed out of the financial systems resulted in the return of elevated volatility levels and a sharp sell-off in the last few weeks of the quarter.

While our economic outlook is cautious, we are optimistic about the opportunities that are emerging to pick away at outstanding long-term growth franchises for low valuation levels relative to fundamentals. Outperformance in the quarter was delivered by having limited exposure to over-levered financials and energy and materials companies, while at the same time taking advantage of Healthcare stocks where growth and ROIC (Return on Invested Capital) fundamentals were mispriced by the market (like C.R. Bard and Johnson and Johnson).

Consumer Staples and Industrial names dominated the top ten holdings in the portfolio this quarter. Consumer Staples (+9.0%), Financials (+4.9%) and Healthcare (+4.6%) were the best performing sectors over the past quarter in the S&P 500 Index. Energy (-21.6%), Materials (-19.3%) and Utilities (-14.7%) were the worst performing sectors for the quarter. The bottom five performers in the portfolio were from the Consumer Discretionary, Energy and Technology sectors.

Looking forward, we remain cautiously optimistic that we are near a bottom. There is no doubt that the “E” in the markets P/E ratios (a relative measure of value) are overstated and that estimates (pretty much across all industry segments) will have to decline to reflect the reality that a rapid tightening of credit and fears of recession (or should we say depression?) is leading to halts in consumer and corporate spending levels. That said, the market is flat on ten years, and unlike previous market crashes, we are starting this downturn in the market from “normal” valuation levels (unlike the excessive valuation seen in the market before the tech boom, the great depression and the Japanese crash). Even with downward revisions, it will be hard to argue that valuations are not at least somewhat supportive that we are nearing trough levels. The key issues remain the unfreezing of the credit markets and a better understanding of how deep the recession goes. Once we have at least some clarity that the financial system will function, the market discounting machine will begin to run properly and we will move away from indiscriminate selling to refocus on fundamentals. Under this scenario, we continue to find outstanding opportunities in Healthcare and Technology sectors.

Global

International equity markets proved susceptible to the global turmoil afflicting credit markets and trended downwards in the third quarter of 2008. The Morgan Stanley EAFE index returned -17.3% (Canadian dollar returns). Inflationary pressures may have receded, but equity markets focused on negative developments arising from the financial industry and the possibility that these may lead to a global slowdown. Though governments and central banks took the appropriate actions to support failing banks, the credit issues have proved more widespread than most anticipated and are proving difficult to contain. A general drying up of liquidity is also wreaking havoc on markets previously thought immune, namely Russia and India. These developments are placing increasing pressure on the global consumer, who was already under stress from higher energy and food prices,



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especially in developing nations. We believe the market is selling indiscriminately and solid opportunities are arising including our recent additions of Diageo, Café de Coral, BAE Systems and Jardine Lloyds.

The fragility of an over-levered European financial system came to light over the last quarter as liquidity quickly dried up and the European Central Bank (ECB) refused to lower rates in light of inflation risks. Several financial institutions proved too weak to remain independent, especially in the U.K. with Bradford and Bingley being the latest casualty. Equity markets were pummeled by the credit crisis, which is proving to be as severe as in the U.S., if not potentially worse. We expect the ancillary impact on the “real economy” to be severe as banks restrict lending and many leading indicators are already indicating weak economic prospects. We expect the ECB to reverse its stance and lower rates in the near future and provide some support to share prices. In our stock selection, we have emphasized high margin business models with strong visibility such as Diageo, the leading global drinks distributor.

Asian markets proved that they remain closely tied to the global economy and are highly cyclical. Support for Asian equities diminished as it increasingly became apparent that exports from China would slow on faltering U.S. and European demand. We remain confident however that China will maintain strong growth as the government takes measures to support the economy. Already the government has diminished banking reserve requirements in order to spur lending. Japan continues to live up to its reputation as the constant disappointment with political turmoil, specifically another change of prime minister, compounding with weakening domestic trends such as lower household spending. Japanese equity market valuations may provide some support with dividend yields above bond yields, however we remain focused on quality franchises with the better long-term growth prospects such as Fanuc.

Emerging markets remained under pressure as inflation surged higher and global growth prospects diminished. Markets previously deemed insulated from the global meltdown proved the most susceptible, especially resource led economies such as Brazil and China, as commodity prices remained under pressure on slowing demand from China. Russia’s predicament was further aggravated by geo-political concerns following their incursion into Georgia. Even China and India were unable to shake off their underperformance of the first half as they reached new lows. Our strategy is to remain underweight in regions exposed to severe economic imbalances, such as Central Europe or India and maintain positions in global leading franchises such as Petrobras.