SECOND QUARTER LETTER 2009

OUR SECOND QUARTER PERFORMANCE

For the quarter ending June 2009, we are proud to report that the weighted average return of our all equity portfolios is now +24.5% year-to-date, which continues to compare favorably to +17.6% for the TSX, +3.2% for the S&P500, and +6.8% for the MSCI World index. Our balanced portfolios have gained between +13% and +20% for the year-to-date, depending on the weighting of fixed income securities in the portfolios. Once again we have achieved these market-beating results with little change to our holdings. We are sticking to our multi-faceted strategy as described in our previous letters. We are getting paid to wait owning safe domestic high-yielding equities and debt securities, defensive and special situation stocks, and slowly building-up positions in companies that produce hard assets such as gold, uranium, oil and agricultural products, as a hedge against eventual inflation and the debasement of currencies. We also continue to avoid the $US and companies dependent on US consumers and global trade, and we remain underweight financials.

During the quarter, notable winners among our top 20 holdings include: Neo Materials (+69%), WiLAN (+57%), Bank of Montreal (+49%), Vicwest (+35%), Vermillion Energy (+32%), Crescent Point (+30%), Logistec (+26%), XEG Energy Index (+23%), Mosaid Technologies (+25%), Calian (+24%), and Stella Jones (+21%). Core holdings which reported record results include Cineplex Entertainment, Shaw Communications, Shoppers Drug Mart, Tim Horton, Velan, VicWest, Calian, and MTY. Also, Calian increased its dividend while WiLAN announced that it will start paying a quarterly dividend. Many of these companies are sheltered from the American consumer, generate significant amounts of free cash flow, have conservative balance sheets, and pay-out generous distributions to shareholders. Our babies, which were thrown-out with the bathwater in 2008, are not only showing a great sense of buoyancy, but many are swimming against a receding economic tide.

FROM GLUTTONY TO FRUGALITY: THE DECLINE OF THE AMERICAN CONSUMER

Much has been written lately about the increasing savings rate of the American consumer, which has gone from a negative rate in 2007 (i.e. the US consumer was a net borrower) to a positive 6.9% of after-tax income in May, the highest rate since 1993. This latest figure may give the impression that our friendly neighbors south of the border have either changed their gluttonous ways or are ready to soon go on a buying binge, but neither is likely. Truth is, like Bernie Madoff, the symbol of capitalist greed incarnate, the American consumer has his hands tied and is now “doing time”. And like Michael Jackson, the ultimate shopaholic, frivolous consumption is dead. The reported increased savings rate is one that is being “forced” upon Americans, driven by lower credit cards limits, cancelled personal lines of credit, home equity loan reductions, mortgage defaults, mounting job losses, tax cuts, and fighting for survival. In order words, Americans are not building-up massive cash hordes, they are paying down mountains of debt. Also, gone are the days when consumers could buy homes, multiple cars, boats, motorcycles, country places, appliances, investment properties, etc… with no cash down. Tighter lending standards by banks and manufacturers now require that consumers shell-out hard cash to pay for goods (or at least for down-payments). This means that consumers have no choice but to save. With consumers accounting for 70% of GDP, the US economy is in big trouble and possibly in a long term decline.

GLOBAL TRADE AND CURRENCIES: THE DECLINE OF THE AMERICAN DOLLAR

The massive deleveraging of consumers and financial institutions, combined with credit contraction by lenders is having massive repercussions on global trade. China's export industry is down a whopping 26% in May primarily because of the decline of the American consumer. This in turn has decimated Japan's exports and so on in a vicious global chain reaction. The massive resulting rise in spare production capacity is hugely deflationary, and this still remains the biggest risk in financial markets (requiring portfolios to have a healthy dose of bonds and high yielding securities). The emergency solution around the planet has been for governments to reduce interest rates and stimulate domestic economies, but this can only be temporary in nature as government deficits and debt swell. Ultimately, competitive currency devaluations will be triggered in the hopes that certain countries will be able to export their way out of their economic doldrums. This is negative for currencies and hugely inflationary in the long run (requiring a healthy dose of assets such as Gold, oil and other natural resources as well as certain equities).

It seems clear now that the recent commodity rally has been driven by short term demand resulting from China's domestic economic stimulus package and stockpiling to take advantage of low resource prices. China is also clearly worried about the declining value of its massive US bond holdings, and is recycling its US dollars into hard assets both as a hedge against inflation and because it will eventually need massive amounts of natural resources as it evolves. In fact, China and other countries are calling for changes to international currency reserves for central banks. This implies a reduced role for the US dollar which now represents around 65% of central bank reserves. The IMF is already increasing its issuance of SDR's (Special Drawing Rights) which is a basket of currencies, seen as a substitute for the US dollar.

THE VIEW FROM HERE: DON'T BELIEVE THE HYPE, IT'S A SEQUEL

STRESS TESTS: MARKET MANIPULATION AND BANK BONUSES

The much hyped "stress tests" for US banks went a long way to calm markets and restore some confidence in the banking system. In reality, the whole process smacked of politicized market manipulation. The stress tests mainly helped financial institutions raise billions in new equity at inflated prices, based on accounting trickery and over-optimistic assumptions. Some banks raised money in order to repay government loans so that senior management's salaries and bonuses were no longer under federal control (akin to being under house arrest). Shareholders who fell for this and bought shares (akin to posting bail money for bank executives) may be in for a big disappointment down the road. The true amount of capital required to keep many of these institutions afloat is much greater than the stress tests suggested, but of course the truth would have spooked investors. Bank stocks have risen dramatically since March pulling the rest of the market up nearly 40% since the March 9th bottom. With increasing loan delinquencies, shrinking assets, a pending collapse of the commercial real estate market, volatile trading profits, and toxic asset valuations artificially propped-up by convenient new accounting standards, bank earnings are as suspect as ever. This suggests that stock markets are vulnerable and investors need to proceed with caution. The fabled "green shoots" may just be sprouts in a forest fire.

CHINA TO THE RESCUE? DON'T HOLD YOUR BREATH

Much has been written about China, India, Brazil, and other emerging markets filling the massive void in demand left by consumers in 4 of the 5 largest economies the world: the US, Britain, Germany and Japan (Europe and Japan are in as bad if not worse shape than America). However, it is just as unlikely that nations of conservative savers (like the Asian countries) will suddenly become wild spenders, as it is for nations of spendthrifts to become disciplined savers. While the Americans are being forced to retrench their spending habits through reduced access to credit, the Chinese are being lured into spending through incentives such as government refunds on the purchase of goods in order to stimulate their domestic economy. Clearly, none of this is sustainable. With an average GDP per capita of just over US$3,300, the Chinese can only pull-out so much money from under their mattresses. Nor can a culture, where thrift is a virtue, be altered so fast. The $2 trillion consumed by China and India (representing 40% of the world's population), pales in comparison to the $10 trillion consumed by Americans (4.5%). Yet, this clearly demonstrates the enormous long term potential of a major shift in consumer behavior in that part of the world, whereby Canada would most certainly be a major beneficiary with its rich natural resource base.

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