

# The BonaVista Quarterly

---

## First Quarter 2010

### Investment Strategy and Review

Following the unprecedented economic events of 2009 we look forward to calmer times ahead in 2010. If 2009 can be characterized as a year of extraordinary financial events, and then 2010 will be a year of “normalization”. We anticipate that world economic growth will turn positive after having experienced a rare global economic decline in 2009. Not since World War II has global economic growth been negative!

Along with this better economic environment in 2010, will come the need to reverse the extraordinary monetary measures that have been in place for the past 1½ years and moving towards more normalized monetary policy. This will bring about the removal of liquidity measures and higher interest rates.

Equity markets globally have moved a long way towards normalization from the trough levels reached in March 2009. At current valuation levels, of 14 – 15 times earnings, we view the equity markets as fairly valued.

With change comes market uncertainties, as a result we anticipate that 2010 will be a more challenging year for markets as we deal with reversion to the mean. Markets will fret about the sustainability of the economic recovery as well as the implementation of monetary policy shifts. We believe that equity markets will be swayed by the positive economic news overriding concerns over monetary policy. With valuation levels in “normal” territory and earnings growth remaining fairly robust we anticipate equity market returns for the year will moderate from extraordinary returns of 2009 to more moderate 8-10% levels.

With normalizing interest rates we feel that returns from the bond market will be minimal this year. Our best-case scenario is that as the recovery takes hold, interest rates will gradually increase during the year resulting in the bond market returns in the 3-4% range.

Our asset mix reflects these views with the portfolio maintaining an overweighting in stocks and underweighting in bonds. Our preference for Canadian stocks over foreign stocks remains as we feel Canada will benefit more from the growth in Emerging Economies and the Canadian dollar will strengthen against the US currency.

### Canadian Equities

The year started out on a very nervous note as sovereign credit problems in Europe and monetary tightening in China, brought some unwanted uncertainty to the markets. As the quarter progressed and evidence mounted that economic growth globally was strengthening, investors were comforted and the Canadian market recovered lost ground and edged higher.

At quarter end North American markets were in positive territory with the S&P/TSX in the lead. Following last year’s extraordinary events we are entering a period of “normalization” where we expect performance to be more in line with earnings expectations. From a valuation standpoint the S&P/TSX is currently trading at 14 – 15 times expected 2010 earnings. At this level it is in what we consider to be fair value territory, as such looking forward we would also anticipate overall annual returns from the market to revert back to a more “normal” 8 – 10% total return for 2010.

This economic recovery will be somewhat different than previous recoveries, which were always dependent on the US consumer taking the lead. This cycle has been and will continue to be led by economic growth out of the developing world. This change in leadership will generate continued high

demand for all commodities from oil to copper, nickel, zinc, etc. This in turn will be very positive for the Canadian economy and the S&P/TSX, which is well represented in these sectors.

During the first quarter, the market was led higher by the Financial Services sector after the Canadian banks reported very robust earnings for 2009, including significant improvement in credit quality and an expectation of a much-improved operating environment for the 2010 period. We anticipate this trend to continue when the insurance companies report at the end of the quarter. At the other end of the spectrum the Utilities index, Consumer Staples and Energy stocks all lagged the overall market.

During the quarter there were no new additions to the portfolio and no major changes to sector weightings. We took advantage of market corrections to add selectively to our current holdings. During the quarter some of the stocks we added to were Atrium, CIBC, Research-in-Motion and Bank of Nova Scotia.

Looking forward, the portfolio is positioned to benefit from the ongoing economic recovery with exposure to the cyclically sensitive sectors of the market such as Materials, Energy and Industrials.

## US Equities

We outperformed the S&P 500 by a small margin over the quarter. The quarterly return for the S&P 500 was 5.4% in US dollars, and just 2.0% in Canadian dollars.

This quarter marked the one-year anniversary of the S&P 500's low of March 9, 2009. From that date to March 9, 2010, the US market has appreciated by 76.8% (all returns in US dollars) with wide ranging returns from the market's sectors. The Financials appreciated by 160.5%, followed by the Consumer Discretionary sector, which rose 109.5%. The "worst" returns came from Telecommunications Services and Utilities, which were up 30.4% and 38.9%, respectively.

Over the quarter, a number of our holdings had very strong returns. Berkshire Hathaway rose 23.7%, General Electric was up 21.0% and Emerson gained 20.4%. Berkshire Hathaway was added to the S&P 500 upon the consummation of its acquisition of Burlington Northern. Berkshire Hathaway was the largest stock to enter the index and the greater recognition has begun to be reflected in its share price. General Electric and Emerson gained on recognition of fundamental improvement in their businesses.

Stocks that lagged over the quarter included Nabors Industries, which fell 10.3% and Alcoa, which declined by 11.5%. Lower levels of natural gas drilling affected Nabors and Alcoa was saddled with low aluminium prices. Both stocks still represent good long-term value.

We continue to see a number of excellent opportunities, among stocks that have both lagged and led the market. Among the laggards, we initiated a position in GameStop, the world's largest retailer of videogames. The stock is down 60% from its 2006 peak, despite increasing its earnings significantly since that time. The company faces a challenge from increased online gaming but has a solid balance sheet, an excellent franchise in used game retailing and trades at an outstanding valuation.

Among companies that have outperformed over the past year, we added to our holdings of General Electric, Norfolk Southern, Bank of America and Allstate. Going into the crisis, the Industrials and Financials were notably weak and over the past year, they have rebounded quite strongly. Each of these companies remains undervalued, while their businesses continue to improve.

Because of relative valuation, we reduced our holdings of Berkshire Hathaway, Cisco Systems and Zebra Technologies and eliminated our investment in FMC Technologies and JB Hunt Transport Systems. At lower prices, we would be eager to re-establish positions in either of FMC or JB Hunt.

Valuation remains the key element in our work. Earlier, we highlighted the Telecommunications Services and Utilities sectors as the areas of "weakest" returns. We have been underweight these groups for a number of years, but are beginning to see greater value among these stocks and will be giving them greater consideration in upcoming quarters.

## International Equities

During the first quarter the fund generated a positive 1.3% return (in Canadian dollars) outperforming the EAFE index, which had a negative 2.4% return over the same period. As has been the case for the past year, the strength in the Canadian dollar versus world currencies has had a negative impact on foreign holdings.

Markets declined in the early part of the year, following the weaker trend of the last quarter of 2009, but recovered somewhat towards quarter end. Concerns remain on the sustainability of the economic recovery, but overall the prevailing view appears to be that the worst of the economic weakness has past. The message we have generally received from companies is of improvements in quarterly sales and orders versus depressed year-ago levels. Emerging markets, such as China and Brazil, were more subdued in the first quarter, compared with the strong positive contribution they made in 2009. The economic environment remains challenging for western governments seeking to finance large government deficits. The Euro zone markets grappled with the economic crisis in Greece, which was seen as putting European monetary union and the Euro currency in jeopardy. In currency-adjusted terms the Euro zone markets were notable laggards especially Spain and Greece. The Fund is notably underweight in the Euro area so this was beneficial to Fund performance. This does not reflect a specific view on the Euro currency but rather the relative lack of opportunities we find in individual securities in those markets.

While we remain underweight in the Financials sector we have added further to existing positions in banks such as HSBC, Banco Popular and Unicredit, all entities that we believe have strong capital positions and good management teams. We eliminated three holdings: Kimberly-Clark de Mexico, Rieter and Heineken. The elimination of Kimberly-Clark means that the Fund no longer holds any positions in Mexico, which is a big change from a few years ago. This is not because we have a negative top-down view on Mexico but rather because we currently cannot find any companies with the quality and value traits we look for. Rieter and Heineken were both sold for quality reasons. As usual we were active in adding to a number of existing positions that remained very good value such as BMW, Travis Perkins and Petrobras. The additions to the Fund had an average normalized price/earnings under 11x and a price/book value of 1.7x. This compared with reductions that had an average normalized multiple of 16.3x and a price/book value of 2.7x. The process of trying to upgrade the combined quality and value of the securities within the Fund never stops.

In the last quarter we added only one new position, Banco Santander, it is a retail focused banking group based in Spain. The bank ranks within the top 3 in market share terms in Spain, the U.K., Brazil, Chile, Mexico and Portugal. Along with a strong capital position throughout the global financial crisis, a major distinguishing feature of Santander in the industry is its unrivalled, proprietary IT banking platform. This has contributed to lower operating costs and cross-selling benefits for the group. It has also enabled the group to integrate acquisitions more efficiently. Banco Santander has a good, steady record of profitability, with ROE averaging 15% over the last 10 years. Conservatively managed, the bank reports a core tier I ratio of 7.5% and financial leverage of 18x. Banco Santander was purchased at a price/book value of 1.3x and a normalized price/earnings of 8.4x.

The Fund valuation characteristics were little changed and at a 13.1x normalized price/earnings, 2.0x price/book value and a 2.6% dividend yield the Fund still represents good value.

## Bonds

North American bond markets began the first quarter of 2010 on a charge, driving prices higher. However, stronger than expected economic data, record government deficits and sovereign debt concerns in Europe, quickly contained the bull. The DEX Universe Bond index returned 1.3% for the quarter and our portfolio matched this return.

In the US, the need for governments to raise debt brought about a flood of new issuances, pushing interest rates higher. The Federal Reserve continues to promote a policy of low rates for an extended period of time. The concern being that higher rates may derail a somewhat fragile economic recovery. In Canada,

the economic recovery appears to be ahead of that of the US. This has pushed rates in Canada up by almost 1% since year-end.

The corporate bond sector continued to benefit from investors reaching for yield and taking on more risk. The high yield market saw several new issues during the quarter, as spreads continue to contract. Corporate bonds outperformed all Government Issue. We still expect spreads to grind lower and have started adding to our portfolio weight in this sector. We added to our holdings of 10-year Manitoba Telecom bonds. This had been a new issue in December 2009 and we bought bonds at that time. The spread compression had lagged other corporate issues so we took the opportunity to increase our exposure. We sold our holding in Manulife Financial 10 year bonds whose spread had narrowed from 498 basis points at time of purchase to 125 basis points at time of sale. With our expectation of a flatter yield curve we also sold several shorter maturity corporate issues and bought slightly longer maturity government of Canada bonds at a pick up in yield.

In the Provincial sector, several provinces brought deals to the market following the release of their budgets. Particularly appealing were issues with maturities less than 5 years and greater than 25 years. Our portfolio is overweight versus the index and we remain comfortable with this position. During the quarter, participated in a 40-year Province of Alberta deal. Although the spread over the benchmark Canada issue was not generous, we seldom see this type of maturity from Alberta and the small size for such an issue was positive for immediate spread improvement. The Caisse de Depot, who are the largest public pension manager in Quebec, issued a billion dollar 10 year maturity bond. The deal was brought to market at 95 basis points over the benchmark Canada bond and 26 basis points over similar maturity Quebec bonds. Because the bonds are reported as part of the DEX Index Provincial sector, we felt they offered good value and bought bonds at issue time and again later in the quarter.

Since the beginning of the year we have seen a substantial flattening of the yield curve in anticipation of higher rates. We initiated several trades to capture the steepness in the shorter maturity part of the curve before the flattening became dramatic. The duration of the portfolio remains quite similar to the DEX.