

The BonaVista Quarterly

Third Quarter 2009

Investment Strategy and Review

What started out as a dismal year in financial markets turned quite positive as markets reacted to the improvement in global economic outlook. While the system is still quite fragile there is mounting evidence that the financial freeze that paralyzed the world last year, has all but dissipated and that the global economy is well on the road to recovery. The Asian economies of China, India, Korea, etc. have already emerged from recession and are in expansion mode, while in North America we are in the process of transitioning from recession to growth.

Equity markets are forward looking instruments and as such have already reacted to the more positive outlook. We see this clearly as most equity markets globally have recovered 30 – 50% of their losses. In order for markets to continue to forge ahead, we need to see solid evidence of the economic recovery. We also need to make some positive judgement about the sustainability of the recovery once it gets underway.

Much of the improvement is simply recognition that the depression, which was being priced into stocks in March, was avoided. There is also recognition that the world will soon be back on a growth path and out of recession.

Valuation levels are not as attractive as they were several months ago, but do remain at below historical levels. As market prices recovered so did the expectations for improved earnings, resulting in reasonable valuations based on price/earnings multiples.

Earnings prospects need to continue to improve in order to maintain positive momentum in the markets. This is likely to be the situation as better expense control and a better economic outlook will deliver revenue growth and better earnings.

Canadian Equities

The S&P/TSX put in an admirable performance for the third quarter rising by over 10% and an even more impressive 30% year-to-date. Our Canadian Equity Fund outperformed the market so far this year by over 10%. This performance resulted primarily from stock selection. We have been positioned for the better part of this year for a rebound in economic activity globally, as such we have been overweight those stocks which would benefit from a resurgence in demand. Those stocks were primarily within the Commodity (base metals) and Energy sectors. At the same time we have been overweight Canadian banks, which have regained most of the lost performance from late last year and earlier this year. The Canadian banks have proven to be some of the strongest capitalized and best positioned banks in the world through this financial crisis.

Of the three large market sectors within the S&P/TSX the Financial Services was the best performing during the quarter, followed by Materials. Energy stocks were higher but did not keep pace with the overall market.

Our portfolio is positioned to take advantage of the global economic recovery, with above market exposure to Commodity and Energy stocks. During the quarter we added one new holding to the portfolio with the acquisition of Genworth MI Canada. Genworth is a Canadian mortgage insurer, which shares the market with Canadian Mortgage and Housing (CMHC); as such it has limited competition and duopoly pricing in its products. While we don't often participate in initial public offerings, we found the valuation of Genworth at less than book value to be compelling.

During the quarter Suncor completed its acquisition of Petro-Canada. We tendered our shares in Petro-Canada and received Suncor shares in exchange. We will maintain an overweighting in this combined company. We believe that the combination provides a great way to participate in a large oil and gas business with lots of growth opportunities and ample cash flow to fund that growth.

The portfolio is positioned with a view towards recovery early in the year and has benefited from that position. Looking forward we believe that markets have ample room to improve from here. One needs to remember that although we have experienced a significant rebound off the lows reached in early March, markets are still well down from peak highs reached in 2007 – 2008.

US Equities

The BonaVista US Equity Fund came in slightly behind the S&P500 over the third quarter. The strength of the Canadian dollar masked the market's 15.6% gain in US dollars.

The US market has maintained its upward trajectory since its low on March 9, 2009, advancing 58% from that date and is now up 19% so far this year. Going back as far as twelve months, the market is now down "just" 7%, a remarkable accomplishment considering recent headlines.

Going into the market collapse, the defensive sectors were the best performers, but have lagged significantly during the share price recovery. Telecommunications Services, Consumer Staples, Health Care and Utilities have all trailed significantly over the past six months. Counter to this, the remarkable S&P 500 rebound has been driven mainly by the prior casualties of the credit crisis: Financials, Materials and Industrials. The Financials in particular have gained a remarkable 142% since March 9.

The recent strength in the US market has revalued a number of our holdings, prompting some adjustments to the portfolio. We reduced our holdings in Masco, a major supplier to the DIY chains, featuring products such as Delta faucets and Behr paint, which is exclusive to Home Depot. The company has experienced a drastic reduction in profitability over the past year, along with many housing-related stocks. Over the past six months, the stock has appreciated by over 300% as the outlook for the housing market has begun to brighten.

A number of holdings have performed well due to their outstanding valuations and the prospect for accelerated capital spending on technology projects that enhance productivity and save energy. The latter "green" strategy is becoming more prominent as companies focus on the "total cost of operation". Accordingly, we reduced our Cisco Systems, Microsoft and Intel positions due to price appreciation, although they all remain substantial holdings.

We also trimmed our exposure to Dell on price appreciation. The company has lost share in the PC market, but is attempting to reverse that trend with a new retail strategy. Additionally, the company is making acquisitions in the software services area, to add to recurring revenues.

Other reductions due to price appreciations were CarMax, JB Hunt Transport and Wells Fargo.

We initiated a position in McGraw-Hill, a major supplier of educational materials in markets ranging from primary through university but most notable for its Standard & Poor's division. The ratings agencies have been soundly criticized for their role in the financial crisis, but we believe that this is now well discounted in the share price.

We added to our holdings of Burger King. The company is one of the few in the S&P500 that is trading below its March 9 level, and represents excellent value. We also increased our investments in Johnson Controls and General Electric.

The market's rapid ascent has left a number of companies behind – notably Walmart. Throughout 2008 and early in 2009, we took profits in this company but its recent weakness has made the stock look increasingly attractive and we added back to our investment over the quarter.

We recognize that the S&P500 has had a significant run over the past six months, but remain comfortable with its value and are even more impressed by the individual stock opportunities that we are able to find within it.

International Equities

During the second quarter the EAFE portfolio contributed positively to overall performance with a 12.5% return compared with a 10.4% return for the MS EAFE index. Year-to-date the fund has also outperformed the index. The returns were hampered by the appreciation of the Canadian dollar versus other currencies.

The outperformance for the quarter was primarily driven by stock selection as a number of holdings, particularly in the financial service sector regained performance as the financial crisis subsided.

There was one new holding added to the Fund during the third quarter.

Fugro provides primarily geophysical survey services. Activities consist of collecting data related to the Earth's surface, seabed and subsurface, analyzing the data and providing advice on the findings. Its services are provided primarily to the oil & gas (accounting for about 70% of their business) and construction/infrastructure industries. Fugro is a world leader with shares generally exceeding 50% in its niche markets. This has contributed to an excellent record of profitability, with operating margins averaging 12% and ROE averaging 29% over the last 10 years. Fugro will continue to grow via bolt-on acquisitions and from the development of new services that can be leveraged across its customer base. The balance sheet is solid with net debt/equity at 54%. Fugro was purchased at a P/B of 2.7x and normalized P/E of 12.7x.

Three holdings were eliminated during the quarter.

Hero Honda, the leading manufacturer of motorcycles in India, was sold for valuation reasons at a P/B of 7.5x and a normalized P/E of 21.3x. Funai Electric, a manufacturer of consumer electronics, was eliminated for quality reasons. Funai's profitability has been negatively affected by the transition to LCD televisions, where the need to outsource LCD panels (about half of total production cost) causes it to be less effective in reducing manufacturing costs and differentiating itself from competitors. It was sold at a P/B of 0.9x and a normalized P/E of 10.5x. STMicroelectronics designs and develops semiconductors. The company remains strong in the development of new products but was slow to recognize the change in the industry to a more fabless approach. Pricing pressure coupled with excess manufacturing capacity have caused profitability to deteriorate. It was sold for quality reasons at a P/B of 0.8x and a normalized P/E of 8.2x.

We added to a number of existing holdings mainly within the Energy, Materials, Industrials, Financials and Information Technology sectors at attractive valuation levels. A number of names were trimmed for valuation reasons, notably Kimberly-Clark de Mexico. Rieter and Allied Irish Banks were reduced following strong performance in September and Ono Pharmaceutical and Telmex were reduced for quality reasons. Banco Popular distributed shares as part of a stock dividend. Singapore Airlines distributed its stake in Singapore Airport Terminal Services to shareholders. We have retained our position in the spin-off.

Bonds

Canadian fixed income markets continued to generate positive returns over the quarter. The DEX Index was up 2.7% for the quarter and 5.6% year to date. An amazingly strong performance from the corporate bond sector has been the main driver of the Universe returns. Year to date, the corporate sector has returned 15.1%. Our portfolio continues to outperform the index.

Despite a heavy issuance calendar of US Treasury bonds, with their one-week on and one-week off cycle, yields recovered from the levels seen at the end of June to close the quarter lower. Although the recovery in the US has hit a few bumps, the Fed is standing firm on steering the economy to recovery via an easy

monetary stance. Their decision not to expand the re-purchase program of US treasury bonds will ultimately lead to upward drifting in yields again.

The Bank of Canada has reiterated its commitment to keep rates at current levels until the end of the second quarter of 2010. This time specific comment could be the catalyst for higher yields in the shorter end of the yield curve.

During the quarter the tone remained positive in the Canadian corporate bond market with financials leading the charge. So far in 2009 bank credit has experienced significant spread tightening. Deposit notes spreads are now approximately 60 basis points from being over 250 basis points in January. These are levels not seen since the summer of 2007.

Corporate issuance has been light in comparison to previous years and several borrowers have chosen to call existing issues. Investors continue to chase after product and have begun to focus their attention on the Provincial sector. Most deals brought recently to the market have been well received by a broad range of accounts. Foreign purchases of Canadian dollar issues has increased helping to draw spreads tighter.

The portfolio's weighting in corporate bonds was scaled back during the quarter. We sold several issues, which had contributed to the funds performance in favour of adding to our Federal agency bonds and Provincial bonds.

The duration of the portfolio drifted longer as we initiated trades to capture the steepness of the yield curve. This will be scaled back to neutral.