The BonaVista Quarterly

Third Quarter 2011

Investment Strategy and Review

The quarter just ended was reminiscent of the dark days of 2008 following the credit freeze. With the stalemates in the US budget and the raging default risks in Europe, the markets reacted with fear selling off all asset classes indiscriminately with the exception of gold and US Treasuries, both of which reached all-time highs.

From a Canadian perspective, we experienced the worst quarter for stocks, the Canadian dollar and commodities since 2008 and at the same time the best quarter for US Treasuries.

Needless to say, our portfolio suffered in this environment. Our overexposure to Canadian stocks and underexposure to bonds and gold resulted in underperformance.

With interest rates in the US at 200 year lows, we find the bond market wildly overpriced and with the yield spread of stocks over bonds at historically high levels, stocks not only provide a very attractive valuation level but discount a severe recession.

As tensions in Europe ease and growth in the US, and globally resumes, interest rates will go up and stock prices should normalize just as in late 2008 and early 2009. Now is not the time to panic and sell stocks, rather it is the time to take advantage of valuations to buy stocks for the long run and upgrade the portfolio where possible. With interest rates at such low levels pension obligations can't be met by buying bonds, once the environment normalizes investors will return to stocks markets for long term performance.

Corporations have strong balanced sheets, earnings growth and the ability to expand overseas to take advantage of better economic growth elsewhere. With interest rates already at 200 year lows the bond market has no direction to go but down. We may be wrong in the short term as fear keeps people rooted in the safe haven US Treasury, but over the medium to longer term interest rates will rise from these levels.

Our view is that economic growth globally was impacted by several temporary factors during the middle of the year which resulted in a slowdown, not a recession. We believe that over the next few months two major factors will influence markets. Firstly economic indicators will improve, signaling a resumption of growth and secondly a more permanent solution to the European debt crisis will materialize. These two factors will ease market fears and allows stocks to mover higher as bond prices move lower. As such we will not panic in the face of lower stock prices but rather take advantage of this opportunity to deploy cash and buy stocks at very attractive valuations. We have taken advantage of very high bond prices to reduce exposure to bonds in anticipation of normalizing yields ahead.

Canadian Equities

The S&P/TSX experienced its worst quarter since 2008, ending down 12.0% resulting in year-to-date also being down 11.9% following a flat first half performance. All major GIC sectors were lower with the exception of Utilities which was up 2.4%.

The cyclical sectors were the hardest hit with Energy -19.3%, Industrials -18.8% and Information Technology -18.8%. The Materials sector experienced some of the worst performance, with Diversified Metals down 40.5% but also the best performance with Golds up 6.3%, out pacing all other sectors during the quarter. The Gold sector is a significant part of the S&P/TSX representing close to 14% of the market, and as such had a material effect on overall performance. Our Canadian portfolio has historically not invested in Gold stocks as we feel these companies have inferior operating metrics and do not represent good value. The underweighting in Golds helped us outperform the market during the first half of the year, but is responsible for the large underperformance we experienced during the third quarter. As uncertainties over Europe quiet down, the price of Gold should correct and we feel these stocks will underperform.

During the quarter we took advantage of sharply lower prices to add to positions we currently own at very attractive prices. We increased our weighting in the Energy sector which was hard hit by the downturn by adding to Canadian Natural Resources, Suncor and Precision Drilling. In mining we added to Hudbay Minerals, Teck Resources and Quadra FNX. At the same time we eliminated our position in Cameco Corp. and replaced it with Methanex Corp.

After the earthquake in Japan we feel that the nuclear industry will face setbacks creating a headwind for recovery in Cameco's stock price. Methanex will benefit from increasing demand from China for methanol as an additive to fuel.

Other positions we added to include Open Text and Quebecor, both at very attractive valuations.

While we have been on the wrong side of this market decline over the past quarter, we are also of the opinion that the economic environment is in better shape than the current market view, so we maintain portfolio positions anticipating better economic data ahead.

Our strategy is to upgrade the quality of the overall portfolio where possible while adding to oversold and undervalued positions.

US Equities

The U.S. market weakened in the third quarter, returning -13.9% in U.S. dollar terms and -7.0% in Canadian dollar terms. Early in the quarter, it became apparent that the economic recovery that had been ongoing since 2009 was beginning to slow down. It was first apparent in a number of news releases from select industrial companies, and became much more obvious during the "earnings season" when companies were reporting their results for the second quarter and outlining their outlook for the remainder of the year.

As was the case in the previous quarter, defensive sectors, including Utilities, Consumer Staples and Health Care, delivered the best returns during the quarter. The Information Technology sector also did well, after lagging the market over the twelve months ending June of this year. In line with some disappointing earnings, the Industrial sector was weak. Financial Services stocks continued to underperform, more due to credit concerns among European banks and the persistent weakness in domestic residential real estate. In contrast to their stock performance, earnings in this sector continue to make solid progress, recovering from the 2009 lows.

As if the nascent economic weakness was not enough, the rancorous debate surrounding the U.S. debt ceiling played a role in undermining business confidence. The near-term solution to emerge from the episode was the formation of a bipartisan super committee, charged with finding an answer to America's debt difficulties. In the event that a negotiated resolution is not attained, immediate cuts to health care and defense will follow. Fearing the worst, many of the stocks in these sectors were much weaker in the aftermath of the announcement. As frustrating as politics can be, it can also create excellent investment opportunities.

We added to holdings of Becton, Dickinson and Gilead Sciences and initiated positions in Varian and Waters. These stocks are companies that supply hospitals and clinical laboratories, all of which were negatively affected during the quarter due to fears over reimbursement cuts. However, all are well positioned for the soon-to-be revamped health care landscape. Becton, Dickinson is a supplier of low-priced consumables, present throughout every hospital in America. Varian manufactures cancer radiation equipment that offers cost-effective, timely treatment. Waters manufactures high-end analytical systems that are central in the health care, food and water safety industries. We also initiated a position in VCA

Antech, which is America's largest chain of veterinary clinics and animal hospitals. On a relative basis, the Health Care sector is the one we are the most overweight.

We made a number of changes within Financials, another sector that we have an overweight position. We re-established a position in Aflac as the shares came under pressure with concerns over European sovereign debt. Aflac holds a number of European credits in its investment portfolio, but has greatly reduced those positions over the past six months and is now trading at levels not seen since the height of the financial crisis in 2009. We also eliminated positions in Allstate and Bank of America over quality concerns, preferring to add to our holdings of Berkshire Hathaway, a company that is trading at historic valuation lows and is poised to come out of the period stronger than ever. Perhaps the strongest measure of Berkshire's undervaluation was the company's announcement that they would begin to repurchase their shares – only the second time in their history that they have taken that action.

The sector where we are most underweight is Consumer Discretionary. In that group, we eliminated our position in Home Depot. The company has done well over the past three years, outperforming the market by a solid margin and we sold it on the basis of it reaching a full valuation. We also reduced our position in McGraw-Hill during the quarter. The company has done well over the past two years, with its earnings expected to surpass its previous peak levels reached in 2007. Over the course of the quarter, an activist shareholder group took a position in the company, suggesting that the company reorganize itself to maximize shareholder value. Additionally, the company's Standard & Poor's segment made international headlines with their downgrade of the U.S. debt rating to AA+ from AAA. Amidst the controversy, the stock has continued to do well, and we reduced our position.

Many stocks in the US market are trading at their most attractive valuation levels of the past ten years or more. We have been able to purchase top quality companies across a range of industries at levels that should provide very rewarding returns over our investment horizon.

International Equities **(commentary provided by Sprucegrove Investment Mgmt Ltd.)**

Third quarter returns from global equity markets did not make for happy reading with the MSCI EAFE Index return at -12.5% in Canadian dollars (-15.7% in local currencies). For the one year period ending September, the benchmark return was -7.9% (-10.8% in local currencies). Despite emerging markets' ostensibly better outlook for long term economic growth the returns lagged those of developed with a -16.4% return in Canadian dollars.

Looking at Fund performance for the quarter, the satisfaction of relative outperformance is muted by the absolute return figures. While it was helpful to be underweight in Financials, the bigger picture concerns for economic growth meant Materials, Industrials and Consumer Discretionary (all overweight in the Fund) were weak. While we did reduce a number of consumer names for valuation reasons, we remain comfortable with our holdings in the sector. Structurally there was no substantive shift in geographic exposure; indeed this is unlikely in any quarter given our careful stock by-stock selection process. The Fund continues to have a close to market weighting in Japan and as a result an exposure to the Pacific markets similar to the benchmark. As commented in our second quarter report, our exposure to Euro-zone markets remains well below the benchmark. Similarly the Fund is underweight in Europe as a whole, despite being substantially more than market weighted in Switzerland. There was not any significant change in our emerging market exposure and this remains a distinctive Fund attribute relative to the EAFE benchmark.

As has been well chronicled, the Euro-zone crisis continued to be a major concern and uncertainty for markets despite the traditional summer lull in Europe. Notwithstanding an apparent agreement on a new bail-out for Greece, it seems that most market participants still expect a default. Other countries got caught up in the cycle of fear over debt levels included Italy and Spain. Europe appears to move from one emergency summit to the next but as yet no one in a decision- making capacity seems to have an answer to satisfy market concerns. Back in August, the crisis in the U.S. over the debt ceiling limit negotiations merely added to the drama. We have to label it "the continuing saga". The high level of uncertainty is clearly darkening the picture for global economic growth, which of course is not helpful at a time governments are seeking to raise additional tax revenues. The companies we speak to certainly hint at softness but do not seem to be predicting acute distress. We will continue as ever to evaluate the individual holdings in the Fund for any signs of deterioration in quality and ensure that conservatism is built into our projections for future profitability.

We added two new holdings in the quarter, Ambuja Cements from India and Straumann from Switzerland. We eliminated one holding in Europe, UniCredit, the Italian bank, as we concluded the risks to their capital base and the challenges of Italy left us feeling uncomfortable with the risk profile, despite the apparent low valuation.

The Fund valuation characteristics at the end of September show the Fund had a normalized P/E of 10.7x versus 11.1x for EAFE, a 1.6x P/B versus 1.2x for EAFE and a 3.5% dividend yield versus 3.9% for EAFE. The projected ROE for the Fund at 15.2% was little changed over the quarter but still compares favorably to the benchmark at 11.0%, while financial leverage at 2.0x remains superior to EAFE at 2.7x. The quality measures of the Fund are greatly superior to those of the EAFE Index, while the valuation is only marginally more attractive. We are satisfied with the Fund's similar valuation level relative to that of the benchmark, because it is at least partly explained by the Fund's significant underweighting in Financials (9.8% versus 22.1%), a sector that is lowly valued at 0.7x P/B, but where there are still significant quality issues. The top ten holdings account for 25.4% of the Fund. We believe all are excellent companies and a simple averaging reveals they sell at a 9.7x normalized P/E, 1.6x P/B and a 4.1% dividend yield with financial leverage of 1.9x and a projected ROE at 16.6% helping to further underscore our belief in the quality and value in the Fund.

In summary, the Fund still represents very high quality and good value.

Bonds

During the third quarter the DEX Universe Index had a strong return of 5.1%. Our portfolio outperformed the market during the quarter and year-to-date.

The same themes in the market continued: European sovereign debt concerns and lack of clear signals of a US economic recovery. Longer dated maturity government bonds were the asset of choice for international investors. Our portfolio was underweight this sector as compared to the DEX but we still managed to outperform.

Corporate spreads moved wider over the summer months. An unusually high degree of spread volatility combined with an unclear direction for bond prices made for a difficult market to trade, but also created opportunities that we were able to take advantage of during the quarter. New issuance was steady but easily placed. We added to our corporate holdings, focusing on deposit notes issued by the Bank of Montreal (14 year) and TD Bank (5year). Both issues were priced well within the context of the market but by the end of September were 40 basis points wider in spread. Most of our corporate holdings have a shorter time to maturity and higher credit quality than the DEX, so the portfolio was somewhat insulated.

The Provincial sector outperformed the overall index again this quarter. New issuance was light as the borrowers were more focused on their election campaigns. Foreign buyers continued to put money into this sector of the market. Our portfolio is overweight provincials and this positively contributed to performance. We sold our 10 year Province of BC bonds in favour of longer maturity Quebecs. This was done at a substantial yield pick-up.

We have adopted a cautious approach for our portfolio as we head into the last quarter and remain neutral regarding interest rates and conservatively positioned regarding credit exposure. With both of the Federal Reserve and the Bank of Canada out of the game for higher rates the market will continue to be focused on political risk in the near term, and anaemic economic growth going forward.