

The BonaVista Quarterly

Fourth Quarter 2009

Investment Strategy and Review

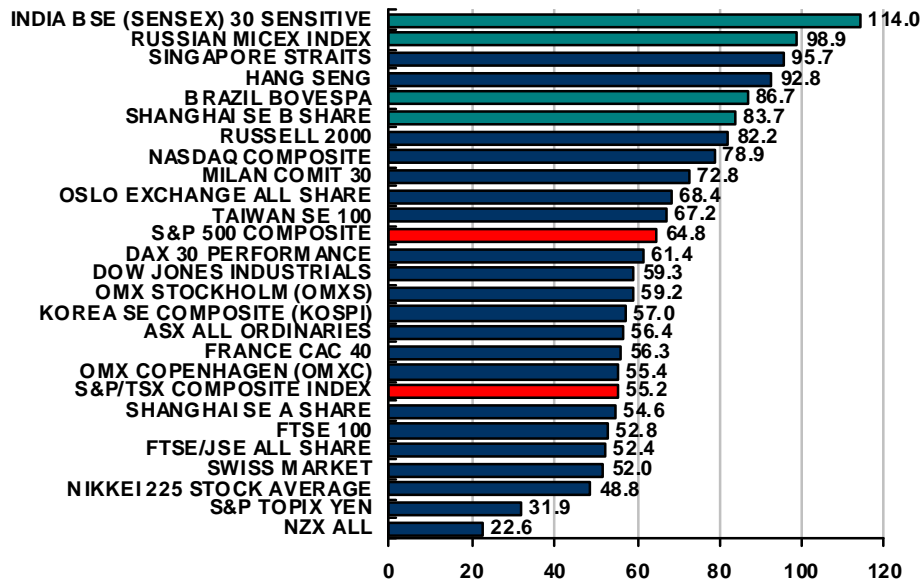
As 2009 began we were in the midst of a financial crisis unlike anything experienced since the late 1920's. Markets were in upheaval and economies around the globe were in deep recession. This cataclysmic environment had the potential to push the world economy into a "great depression". Only through the coordinated efforts of the Federal Reserve and Central Bankers around the world was a "depression" avoided, but avoid it we did. From a portfolio standpoint we felt that as the year progressed we would go from a very bad economic environment to one that was "less bad" and eventually something that would be a more "normal environment". While we have not yet graduated to completely "normal" status we are very close. The positive performance by the markets was a reaction to having avoided the depression.

Looking forward we believe the recovery is broadening out as more countries turn from recession to growth. The Asian economies were the first out of recession, with the rest of the world following behind. Economists are now talking about "synchronized global growth" in 2010. We also anticipated that inflation will be contained and overall earnings will improve. This will have a positive impact on stock markets, but possibly a negative one on bonds as interest rates begin to edge higher.

For now we are comfortable maintaining our asset mix exposure as it stands. Equity markets are attractively valued relative to bonds or cash. Our preference to Canadian stocks also remains intact as we like the higher exposure to commodities and well positioned financial institutions, which the S&P/TSX gives us.

Global benchmark returns since market trough (March 9, 2009)

(NBF Economy & Strategy (data via Datastream), as of Dec. 31, 2009)



Canadian Equities

Over the course of the year, the S&P/TSX regained about 60% of its value from the multi-year lows reached in March, but that performance left the overall market still about 20% below the peak reached in June 2008. Nonetheless this was the best year for the S&P/TSX since 1983.

Good stock selection during the year was the primary source of value added to the portfolio. The portfolio was structured to take advantage of a recovery in global economic activity. An overweighted position in cyclical stocks for both the base metals and energy sectors of the market helped returns.

Some of the basic themes we implemented over the year were:

1. a preference for oil levered companies rather than gas levered companies
2. we preferred bank stocks over insurance stocks
3. we emphasized base metal stocks rather than gold stocks

All three of these themes proved to be accretive positions relative to the market. While the portfolio benefited greatly from these themes we don't believe it's time to change our stance. All three themes remain intact.

With global growth being led by the developing economies of China and India, we continue to favour commodity stocks, particularly ones with exposure to copper and zinc, as well as oil.

For the year the best performing sectors of the market in Canada were Financials (+45.6%), Information Technology (+44.3%) and Energy (+39.5%). Within these sectors there were very large differences among the various components, as an example banks (+62.6%) outperformed insurance (+11.3%). The third largest sector of the market, Materials, slightly underperformed the market with a 34.2% return, but within this sector was some of the widest differences in performance, as diversified metals and mining (+323.9%) outperformed gold (+6.33%) by an astounding amount. Gold stocks lagged the overall market despite the fact that the price of gold reached an all time high of \$1,215 in December 2009.

During the fourth quarter of the year we added two new names to the portfolio. The first was Shoppers Drugmart, which is Canada's largest operator of retail drug stores. Shoppers is a very well managed company with good levels of growth and profitability, as well as an excellent balance sheet. The stock price lagged the overall market as concerns regarding changes to drug cost reimbursement rules cast a negative sentiment on the business. We took this opportunity to add Shoppers to the portfolio at very attractive valuation levels. Secondly we added Gran Tierra Energy to the portfolio. This company is an oil and gas exploration and producer with operations in Colombia. The management team is made up of well-seasoned executives from some of Canada's largest most successful E & P companies. Gran Tierra is currently drilling in some very prospective areas of Colombia and Peru with the potential for significant growth. The company has a great balance sheet and positive cash flow. Stocks at this stage of development tend to have higher-risk profiles and as a result we will limit the exposure within the portfolio, but we view the risk/reward ratio as favourable.

Looking forward, 2010 will be a more challenging year for markets as companies will now have to live up to the expectations built into the rising stock prices. As global economies transition from the induced growth provided by the liquidity injected by central banks and fiscal stimulus money, to one that needs to become "self-sustaining", markets are likely to become nervous. Given still reasonable valuation levels we continue to like equities but will be carefully watching as the year unfolds. Overall we expect more moderate returns in 2010 but still positive.

US Equities

With the passage of time, the US market has advanced significantly from the low that was set on March 9, 2009. At that point, the market had declined 55% (in US dollars) from its peak on October 9, 2007 – a seventeen month slide. That decline represented the worst market since the Great Depression, and the robust gain that we have seen over the past ten months (+68%) is also the best since the 1930's.

Even after the remarkable increase in the market, we are still able to uncover a number of attractive investment opportunities. Increased merger and acquisition activity is another sign of the value within the US market.

We initiated a position in Cedar Fair, an operator of amusement parks in the US and Canada. The company acquired Paramount's amusement park operations in 2006. With the weak economy of the past eighteen months, the company experienced its first revenue decline and with lower earnings, eliminated all cash distributions. The shares declined to very attractive levels and we began to build an initial investment in the stock, but soon thereafter the company accepted a leveraged buyout offer (LBO) from Apollo Investments. This is the first LBO in quite some time and while our position was not overly large, it highlights the value that we are seeing in US stocks.

On a more substantive note, XTO Energy, a leading US natural gas producer, accepted a takeover bid from ExxonMobil. This is the largest acquisition of a domestic US exploration and production company and provides another example of the investment value that is being recognized in the market.

Also within the Energy sector, we added to our investment in Valero Energy – the leading US independent oil refiner. Lower "miles driven" are translating into less demand for gasoline, diesel and other refined products. In response to the near-term challenges, the company has announced the closure of an East coast refinery which will provide some future relief. The stock trades at valuation levels not seen in over ten years, and we are taking advantage of the share weakness to add to our holdings.

We also made a small addition to our Nabors Industries holding. The company is heavily exposed to the North American natural gas markets, and should benefit from the additional drilling that will be required to bring all the newly found shale gas prospects on line.

We trimmed our position in FMC Technologies, a leader in design and implementation of subsea systems for deep water oil drilling. The company's shares have rebounded strongly along with the price of oil, and we have trimmed on account of the gain.

In the Materials sector, we added to our position in Mosaic Industries with the expectation that the current earnings weakness will be remedied by a rebound in global agriculture markets. We are seeing early signs of this and Mosaic is trading at a compelling valuation.

Our position in Schering-Plough was eliminated upon the consummation of its merger with Merck. We also made smaller incremental additions to both Emerson and Allstate.

The market's rebound over the past ten months has been spectacular, but a number of companies have not participated in the rally – notably among the market's more defensive groups. As a whole, the Consumer Staples sector has "only" gained 41% since the March 9 market trough. It is remarkable this level of return is considered "lagging". Still, a number of these stocks represent much better value than the market at this point, featuring steady businesses that should provide a solid margin of safety through what may be a slow and deliberate economic recovery.

International Equities

The strengthening Canadian dollar had a negative effect on returns from foreign stocks, however, even in Canadian dollar terms the EAFE fund was up 17.3% for the year, well ahead of the 13.1% return of the Index and also well ahead of the performance of the US stocks.

The outperformance over the year is attributable to good stock selection as well as good country allocations. The Fund's high exposure to Emerging Markets (up 62.3% in Canadian currency) was a large contributor, as these markets outperformed EAFE by a significant margin. The Fund also benefited from being underweight some of the poorer performing markets such as Japan (down 9.8%) and Greece (up 63%). Although sector weightings are arrived at on a bottom up basis, the Fund is structured to benefit from an improving global economy. The largest sector exposures are to Consumer Discretionary and Industrial with and underweighting in the more defensive areas of the market, Consumer Staples and Utilities.

In terms of stock selection the top five contributing stocks were:

Swatch, the world's biggest watch maker, was higher after releasing financial results for the first-half of 2009. Watch sales performed rather well in a difficult economic environment. Second-half sales were projected to match the same period last year. Petrobras, Brazil's state-controlled oil company, rose with crude oil prices making gains. There was no company specific news for Samsung Electronics. Signet, the world's largest jewellery store owner, was higher as management provided an encouraging report on their start to 2009. In addition, Signet successfully amended borrowing agreements to better suit its needs. Carnival, the world's biggest cruise line operator, was higher after increasing its full-year 2009 earnings targets.

In terms of negative impact exposure to health care stocks in Japan and the telecommunication sector in general, were detrimental to overall returns.

During the fourth quarter of the year the fund added three new names to the portfolio: Sembcorp Industries is a leading provider of multi-utilities and marine engineering services. Multi-utilities offers integrated utility services such as power, steam and wastewater to industrial customers on Singapore's Jurong Island and in Teesside in the U.K. Marine engineering services includes ship repair, ship conversion and offshore and rig-building activities. It was purchased at a P/B of 2.1x and a normalized P/E of 13.9x. Hisamitsu is a Japanese pharmaceutical company that specializes in the use of skin patches for drug delivery. Sales are dominated by the Mohrus brand of prescription patches and tapes which have a 51% share of the Japanese pain-killing and anti-inflammatory adhesive patch market. Overseas sales are very small (3%) but Hisamitsu does have some products in its U.S. development pipeline. It was purchased at a P/B of 2.0x and a normalized P/E of 13.3x. China Mobile is the leading mobile services provider in China with a 73% market share. It was purchased at a P/B of 2.7x and a normalized P/E of 12.6x. Telmex was eliminated for quality reasons.

Bonds

In December 2008 the 30 year US Treasury yield hit a 200 year low at 2.6%. We believe that will prove to be the end of the long bull market for bonds. As 2009 progressed yields on treasuries steadily climbed as a steady diet of new treasury offerings were supplied to the market. By year-end 2009 the 30 year treasury was yielding 4.6% up 200 basis points from year earlier levels. The saving grace for the bond market in 2009 was the amazing retrenchment in corporate spreads from historically high levels brought about by the financial crisis to something approaching "normal spreads". This contraction in spreads resulted in reasonable returns from the overall bond market for the year. The portfolio outperformed the market for the year.

However, having seen the lows in yields for this cycle and with spreads back to more normal levels, we believe that the prospects for returns from the bond market in 2010 will be limited. The prospect of record government supply and higher rates took its toll on bond prices during the final quarter of the year resulting in negative returns

Yields on US Treasury bonds rose sharply as the end of the year approached. Improving economic data and super-sized Treasury auctions weighed heavily on the market. The Canadian market outperformed the US slightly over the year. We expect that bond yields will grind higher over the course of 2010 amid massive deficit financing in the US, an end to quantitative easing and the countdown to central bank tightening.

The corporate sector was again the driving force behind market performance. New supply was scarce relative to previous years. In the DEX Index the corporate sector returned 16.3%, which was 3 times the overall market's performance. Federal bonds returned -0.2% for the year. We pared back our exposure to corporates as spreads tightened. By year-end our portfolio had a 20% weight in corporates versus 27% for the index. We anticipate supply will be abundant in 2010 in a low interest rate/tight spread environment. This will provide us with many opportunities to increase our holdings again.

Provincial bonds were the "sleeping giant" of the Canadian bond market last year. The total return for the sector was 4.7%, which lagged both the corporate and municipal sectors of the index. New issuance was at the highest levels in five years as provincial deficits deepened. Although spreads recovered from the wide levels of 2008, their recovery was modest when compared to corporates. With global economic activity picking up and commodity prices improving we believe the provincial sector still offers good value. The portfolio is currently overweight the sector, 32% versus 24% for the index.