

# The BonaVista Quarterly

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## Fourth Quarter 2011

### Investment Strategy and Review

2011 was a difficult year for investors as markets were subjected to an onslaught of bad news emanating primarily from Mother Nature and “politicians”. Surprisingly, the economic news wasn’t all that bad, other than a mid-year slow down. The havoc unleashed by Mother Nature and the inability of “politicians”, both in the U.S. and Europe, to act decisively in addressing government credit problems was more than enough to send markets back into panic mode. The uncertainty created by the political bickering worsened what was already a big credit problem in Europe and weakened the already bruised business confidence both domestically and abroad.

In a more confident environment the economic weakness emanating from government austerity programs could be offset by business expenditure and capital investment, but the high level of uncertainty has hindered business confidence and market appetite for risk taking. Markets can deal with bad news, its uncertainty they don’t like. As we approached year-end some of the dark clouds were beginning to part.

On the economic front, economic data was improving in the U.S.; the developing economies, which had been tightening were beginning to loosen monetary policy to stimulate growth. In Europe the ECB had found a mechanism to provide ample liquidity to all European banks (reducing the specter of a financial contagion emanating from the banking system). On the political front it appears as though the rhetoric out of Washington has peaked at least for now!

Corporate profits continue to be robust and balance sheets strong putting equity valuations at attractive levels. The direction markets take over to the coming year will ultimately be driven out of Europe. We believe that Europe will “muddle through” to a solution, as a breakup of the European Union would put all countries involved in a worse position. It is in no-one’s interest to have the European Union dissolved.

While risks remain, we believe that the markets have priced in much of the downside. We will maintain our approach to the markets keeping a vigilant eye on the proceedings in Europe, the USA and the global economy.

## Canadian Equities

The Canadian equity portfolio underperformed the market for the year primarily as a result of being overweight in Diversified Materials stocks which as a group significantly underperformed the market. The portfolio was also underweight the better performing sectors of Telecom Services and Utilities. This combination accounted for the bulk of the underperformance relative to the market. Political uncertainties and supply disruptions during the year led to a mid-year economic slowdown which unnerved markets globally.

In Canada the hardest hit sectors were the more economically sensitive areas of Materials, Consumer Discretionary and Energy. While Financials globally were negatively impacted by what is happening in Europe, the Canadian banks are in solid financial shape and not as affected. Within the financial sector in Canada it was the Life Insurers that were the most negatively affected by market dynamics.

On a fundamental basis, earnings overall were higher for the market in 2011, up an estimated 20% from 2010 as were dividend increases. However the market uncertainty and increased volatility resulted in lower price/earnings multiples being awarded. At year end the S&P/TSX was trading at a price/earnings multiple of 12.6x compared with 15.8x at the end of 2010. On an historical basis, this valuation level is below normal, more importantly, when comparing the equity market earnings yield of 7% against a 10 year Canadian Government bond yield of less than 2%, the equity market is extremely undervalued relative to bonds. One would have to go back to the dark days of the 2008-2009 financial credit freeze to find a similar valuation gap.

The structure of the portfolio did not change markedly over the course of the year. The volatility during the year gave us the opportunity at different times to both trim positions and lock in some profits as well as add to some of our favourite holdings at great prices.

During the second half of the year we initiated positions in two new holdings, Potash Corp. and Methanex. Potash Corp. is the world's largest producer of potash fertilizer as well as the lowest cost producer. This profitable company has always traded at a significant premium to the market. Given the global uncertainties and some weakness in the potash market, the premium has shrunk. We are taking this opportunity to initiate a holding in this well-run company at an attractive valuation. Methanex Corp. is a global supplier of methanol (a fuel additive) through its operations in five countries around the world. With increasing demand for methanol, particularly from China, we believe Methanex will benefit from higher prices for methanol and increasing volumes as it expands operations.

Better economic growth globally will go a long way to addressing the issues currently being faced in Europe, the U.S. and parts of Asia. The U.S. economic data is improving and China appears to be loosening monetary policy. Both will be welcome news to equity markets.

## US Equities

The U.S. market strengthened in the fourth quarter, with the S&P 500 Index returning 11.8% in U.S. dollar terms and 9.3% in Canadian dollar terms. The strength of the final quarter put the full-year performance of the S&P 500 “into the black” – returning 2.1% in U.S. dollars and 4.6% in Canadian dollars.

During the fourth quarter, the U.S. market managed to climb the proverbial “wall of worry”, despite no real sign of economic growth, continuous political bickering and the failure of the “super committee” to yield a resolution to the challenging domestic fiscal position in the U.S.

Over the full year, the strength posted in the fourth quarter was not enough to displace the dominance of defensive sectors. The strongest-performing sectors over the year included the Utilities, Consumer Staples and Health Care sectors; the weakest results came from Financials, Materials and Industrials. The Financials were the only sector to underperform the market in each and every quarter.

We did relatively few trades over the course of the quarter. Within the Industrials sector, we reduced our holdings of General Electric due to price appreciation and relative valuation and added to our positions in Emerson Electric and United Technologies. This was an instance of a quality upgrade.

Emerson Electric develops and manufactures process control systems and analytical instruments for a range of fields – from network power to food processing. The company pre-announced weak earnings for the fourth quarter and we used that opportunity to add to our existing position. The company is trading at the low end of its valuation range, relative to its diversified industrial peers, and is a high-quality company that generates superior returns on shareholder equity.

United Technologies is a diversified global manufacturer that researches, develops, and manufactures high-technology products in numerous areas, including Otis elevators, Sikorsky helicopters, Carrier air conditioners, and Pratt & Whitney airplane engines. The company has an exceptional financial track record and is trading at historically inexpensive levels.

Due to valuation considerations, we reduced our position in Intel and added to Mosaic, a fertilizer company that had seen its share price drop due to recently lowered expectations for corn and wheat prices.

Finally, within the Telecommunications Services sector, we initiated a small position in Iridium Communications, the world’s second largest provider of mobile voice and data communications services via satellite, and the only commercial provider of communications service offering 100% global coverage.

## International Equities

The Fund outperformed the MSCI EAFE both the fourth quarter and the year. The Fund outperformance for the year was attributable to an underweight position relative to the Index in Financials as well as stock selection in Materials (CRH, Air Liquide) and Utilities (CLP Holdings, Snam Rete Gas). The most notable detractor to performance was the underweight position in Consumer Staples. From a country perspective, the Fund outperformed due to stock selection in France (Total, Air Liquide), Germany (adidas, BMW) and Japan (Santen Pharmaceutical, Komeri). This was slightly offset by a negative contribution due to stock selection in the U.K. (HSBC, Carnival) and the Fund's exposure to emerging markets (Hindalco/India, Impala Platinum/South Africa). Over the one-year period ending December 31, 2011, the Canadian dollar weakened versus the majority of currencies, with the notable exception of the euro. The net effect was a positive impact to returns in Canadian dollars.

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

Hongkong Land is a leading Asian property investment group. The company's principal assets are prime office and retail properties located in the Central Business District of Hong Kong. Tenants include some of the world's leading financial, business and luxury retail entities. Hongkong Land is recognized for offering premium services to its commercial tenants and consistently maintaining the quality of its assets. Management has leveraged its brand and expertise by expanding to other leading properties in a number of cities in the region, principally in China, Macau and Singapore. Its record of profitability is solid, averaging 13% ROE in the last decade. Management is conservative and has maintained a very strong balance sheet since the 1990s, with net debt/equity currently at 12%. Hongkong Land was purchased at a 3.7x normalized P/E and a 0.4x P/B.

Two holdings were eliminated from the Fund in the fourth quarter.

Signet Jewelers is the world's largest specialty jeweler, with operations predominantly in the U.S. and U.K. It was purchased for the Fund as a U.K. holding in 2005. However, in 2008, the company moved its primary market listing from the U.K. to the U.S. and its domicile to Bermuda. We have not added to our Fund position since 2008. In May 2010 MSCI reclassified Signet from a U.K. to a U.S. company. Accordingly, we concluded that Signet should be considered a U.S. company, which is outside of the mandate of the Fund. Our plan to eliminate Signet from the Fund over the course of 2011 has now been completed.

With over 50% market share, SK Telecom is the dominant wireless telecom company in South Korea. It has the country's most advanced and extensive wireless network along with the leading brand. In addition it was a global pioneer in offering wireless data capability to customers. SK Telecom has always maintained a sound balance sheet and ROE has averaged an impressive 20% over the past ten years, although this has come under some pressure in recent years as the market has matured and become more

competitive. Over this same period, however, its telecom-related ventures overseas in pursuit of growth have been less successful. Unfortunately it was this penchant for growth that led management in July 2011 to acquire a major stake in Hynix Semiconductor, the world's second largest maker of memory chips. Our big issue with the deal is the limited synergy between telecommunications and chip-making. Future performance could also be adversely impacted by the cyclical nature of the semiconductor industry. We expressed our strong opposition to management and the Board, as did others, but the influence of the controlling shareholder SK Group has regrettably prevailed. Because of its diminished quality, SK Telecom was eliminated from the portfolio at a 7.9x normalized P/E and a 1.0x P/B.

On average, our additions had a normalized P/E of 10.2x and a P/B of 1.7x versus 14.1x and 2.2x respectively for our reductions.

Overall, the Fund continues to represent better value than the MSCI EAFE with lower price/book value and lower normalized price/earnings value relative to the market, but better projected return on equity, 15.2%, relative to the market, 11.0%.

## Bonds

The DEX Universe Index returned 2.1% for the quarter capping a 9.7% return for the year. Our portfolio outperformed the market during the quarter and the year.

The factors which drove the Canadian bond market to higher price levels in previous months continued. Investors in Europe, Japan, America and China all had an appetite for the safety of Canadian bonds. Provincial bonds performed very well again this quarter despite a heavy supply calendar. The sector has benefitted from strong international demand for longer dated maturity issues. Our portfolio is still overweight provincials and this contributed positively to performance. At current spread levels there is no compelling reason to adjust our sector exposure. During the quarter we added a new position in Province of Manitoba 5 year bonds to the portfolio.

As was the case for much of the year, corporate bonds lagged the performance of the government sectors. Issuance during the quarter was light and trading activity was noticeably thin. Lack of significant demand translated into widening spreads.

Early in the quarter we sold our position in Manitoba Telecom bonds. These had been a core holding within our portfolio for about two years but their performance relative to other issuers in the telecom sector was lagging. We also added a small position in a longer dated GTAA (Greater Toronto Airport Authority) new issue. This issue came at a generous spread relative to other infrastructure names.

Moving forward into 2012 we are approaching the bond market with caution. Despite some mildly encouraging economic data and the Bank of Canada's commitment to hold rates low, the ongoing economic woes of Europe will continue to be the driving force behind bond prices. We will maintain our low risk management style which has again proven to be the best route.