

The BonaVista Quarterly

First Quarter 2008

Investment Strategy and Review

What a way to start the year! What began in 2007 as concern over losses in the sub prime mortgage market, evolved into a crisis of confidence that dried up liquidity in all markets and resulted in the demise of Bear Stearns, prompting a massive rescue package by the Federal Reserve. All this, coupled with an economic slowdown in the US and recession fears, created extreme nervousness and a lot of volatility. It was a quarter you want to forget but will probably become the one that goes down into the history books!

That's the bad news. The good news is that the response from the Central Bankers and the Federal Reserve in particular, has been significant, both in lowering interest rates and more importantly in providing liquidity to the markets. As the quarter came to an end, there was evidence of much needed stability starting to return to the markets.

Financial institutions that were writing down billions in mark-to-market losses were able to access the capital markets (equity) and refinanced their balance sheets.

The stimulus provided by the interest rate cuts along with fiscal stimulus from tax refunds will have a positive effect on the US economy during the second half of the year which will help to stem the current slowdown.

The markets reacted negatively to the financial problems and ended the first quarter down from the year-end levels, but up significantly from the lows of the quarter.

Canadian Equities

The fund performance was negative for the first quarter falling more than the S&P/TSX, which was down (2.8%). Our shortfall in the quarter was primarily the result of not owning a market weighting in gold stocks, which were up over 8% during the quarter and represent about 10% of the total S&P/TSX. We have an underweighting in gold stocks as we feel the valuation is very expensive. The other two big sectors of the market are Financials, which were down 9% and Energy, which was up 2%. While we are fairly weighted in both these sectors, stock selection did not make up for the performance lost to gold.

The S&P/TSX continues to be one of the best performing markets in the OECD countries. We feel that with the help from the Federal Reserve, the markets are beginning to look ahead at the prospect of economic recovery in the second half of the year. As the focus turns away from financial crisis and more to continued economic growth globally, the S&P/TSX, with its large exposure to natural resources will benefit.

Over the quarter the fund benefited from the announced takeover of CHC Helicopters by First Reserve Corporation for \$32.68 in cash, a 42% premium. This transaction is scheduled to close in the second quarter.

We added 3 new positions to the portfolio. BCE Inc., Canada's largest telephone operator, is currently the subject of a takeover at \$42.75 by a consortium led by the Ontario Teachers Pension Fund. As the markets experienced difficulty during the quarter and question the availability of credit to close this transaction, BCE shares dropped to \$33. At this price we felt the stock was trading close to fundamental value. The risk/reward by buying BCE at these levels appeared compelling, particularly since recent developments suggest that some of concerns around completing the deal have been mitigated.

We also added Thomson Corp. to the portfolio. This is a high quality company providing information services to a variety of professions, the 2 largest being lawyers and the investment community. Thomson

is the process of acquiring Reuters Corp., which will make it the dominant player in many of its markets. Concerns about this transaction caused Thomson stock to drop from a high of \$50 into the low \$30's. We purchased the stock at about the \$35 range, where we felt it represents good value.

The third new position into our portfolio is a small exposure to Thompson Creek Metals. We are still constructive on the outlook for commodities and wanted to get some exposure to molybdenum (moly), which is primarily used as an additive to strengthen steel. Thompson Creek, among the Canadian companies, offers the best exposure to moly from its mines in British Columbia.

Looking ahead to the rest of the year, we are optimistic that the efforts to date by the Federal Reserve combined with fiscal policy will have a positive effect on overall credit markets and also work to alleviate and shorten the period of slowdown currently underway in the US economy. With continued global growth led by the Asian economies, commodity demand and prices should remain strong, making Canadian resource stocks an attractive investment opportunity.

Overall equity markets represent good value and we are comfortable with our asset mix at this stage.

US Equities

The US portfolio outperformed the S&P 500 over the quarter, returning (3.7)% against (5.8)% for the S&P 500 in Canadian dollars. For the first time in a while, the Canadian dollar contributed positively to returns, as the market's US dollar return was (9.4)%.

The central concern continues to be the ongoing weakness in the US housing market and its contribution to the widening credit crisis. Both the US government and US Federal Reserve have introduced significant measures to address, and hopefully, stem the economic and financial deterioration, including: the introduction of a fiscal stimulus package; a 200 basis point reduction in the Federal Funds rate and the introduction of a number of measures that allow both commercial and investment banks to "park" a number of securities on a temporary basis with the Federal Reserve. Investment banks have not been allowed access to this facility since the Great Depression, an indication of how difficult the current environment is.

In the Energy sector, we reduced our exposure to Anadarko as the stock had outperformed and no longer represented solid long-term value. The company has successfully digested several acquisitions over the past couple of years and that is being reflected in the company's share price.

We also took the opportunity to reduce our exposure to Illinois Tool Works, which was the portfolio's largest holding at year-end. The stock continues to represent good value, but as a consequence of the overall weakness in the market, more and more opportunities are presenting themselves, including General Electric.

Within the Health Care group, we reduced our exposure to Pfizer, switching the proceeds into Schering-Plough. Pfizer has had mediocre performance over the past couple of years and faces the expiration of its patent on Lipitor, its largest pharmaceutical product, in 2011. At the same time, Schering-Plough had declined significantly early in the year over concerns relating to preliminary results from a study that questioned the benefits of its cholesterol drug, Zetia. The company actively disputes the study's conclusions. Beyond Zetia, the company faces no significant patent expirations over the next five years, has a number of late-stage products in its research pipeline and its shares trades at the most attractive level in years.

We eliminated our positions in two companies during the quarter – Commerce Bancorp was eliminated on account of being acquired by Toronto Dominion, and Sprint Nextel was sold once it became apparent that operational performance, which we had previously expected to stabilize, was degrading at an accelerating pace.

Among the Financials, we reduced our holdings of Aflac on account of price appreciation. Aflac is the leading provider of supplemental medical insurance in Japan and America, generating an exceptional return on equity, and has outperformed the market by 45% over the past year; the stock is approaching the

upper end of acceptable valuations. We took the opportunity to redeploy the funds in several depressed banks, including Fifth Third Bancorp and Wells Fargo.

We are seeing a lot of value among the financial stocks and the market as a whole, and expect rewarding returns over our investment horizon.

International Equities

The Fund return for the first quarter of 2008 was (2.4)% versus a (5.3)% return from MSCI EAFE. All country and sector exposures are a residual of our bottom-up, stock-selection process. The outperformance for the quarter was attributable to an overweighting in both Ireland and Switzerland and stock selection in Hong Kong. From a sector perspective, the Fund outperformed in the Industrials, Materials, Utilities and Telecommunication Services sectors. This was partially offset by underperformance in the Consumer Discretionary sector.

For the one-year period, the Fund return of (13.6)% compared with a MSCI EAFE return of (13.5)%. The underperformance over the one-year period was attributable to an overweight position in Ireland and stock selection in the U.K. This was offset by outperformance in Japan, Holland and the Fund's emerging markets' exposure. From a sector perspective, underperformance in the Consumer Discretionary, Materials and Industrials sectors was offset by outperformance in Energy.

Eight of ten sectors in the MSCI EAFE Index had negative returns for the quarter. The sector with the best return was Materials (+0.2%). The sector with the weakest return was Telecommunication Services (-12.1%).

The Fund continues to have a lower weighting than the EAFE benchmark in the Pacific and in Europe. Within the Pacific, the Fund remains significantly underweight in Japan. Within Europe, the Fund is slightly overweight in the U.K., the largest country exposure in the Fund. Exposure to emerging markets was 13.7%. Cash was 3.8%.

In sector terms, the Fund is most significantly different to the benchmark by being overweight in Consumer Discretionary and underweight in Consumer Staples and Financials.

There were three new holdings added to the Fund during the first quarter. Kingspan is a building materials manufacturer that specializes in niche product areas such as insulated boards and panels, which offers superior organic growth opportunities. The stock was purchased at a 2.2x P/B, 8.9x normalized P/E and a 2.8% dividend yield.

Ushio makes specialized lamps and a variety of related equipment that uses the lamps as light sources. The stock was purchased at a 1.6x P/B, 15.7x normalized P/E and a 1.3% dividend yield. Ricoh manufactures and markets office automation equipment, electronic devices and photographic instruments. The stock was purchased at a 1.1x P/B, 10.8x normalized P/E and a 1.7% dividend yield. One holding was eliminated when the Fund's holding in SCMP Group was tendered to a take-over offer by Kerry Media.

There were a number of additions to existing holdings at attractive valuation levels, particularly within the Industrials, Consumer Discretionary, Financials and Information Technology sectors. A number of holdings were reduced for valuation reasons, particularly in the Materials sector. We were able to reduce exposure to names with an average normalized P/E multiple of 19.5x and reinvest in a range of holdings valued at roughly half that level.

Bonds

Canadian fixed income markets generated strong returns in the first quarter of 2008, fuelled by a flight to quality of Government bonds. The DEX Index reported a 2.96% return. Our portfolio's performance came in slightly ahead.

The Federal Reserve continued its course of lowering rates with three rate cuts, which dropped the Fed Funds rate 200 basis points to 2.25%. These moves along with a new stimulus package helped buoy the bond market, as the threat of recession became top of mind for many investors.

The Bank of Canada cut rates twice during the quarter for a total reduction of 75 basis points. The bank rate now sits at 3.50%. The market anticipates further rate cuts with a 50 basis point cut to 3.00% already incorporated in the current yield curve.

The supply of new issue bonds fell short of market expectations during the quarter. Daily headlines of hedge fund woes, sub prime, ABCP, et cetera were cause enough to drive the price underperformance of the corporate bond sector. The few issuers who did bring their deals to the market priced them at discounted levels to investors.

Spread volatility and the steepening yield curve gave us several opportunities to initiate trades in the portfolio. We participated in two corporate issues, TD Bank 5 year deposit notes and Epcor Utilities 10 year bonds. Both came at what appeared to be generous spreads. However in the current spread environment, both were marked wider by quarter end.

Our portfolio's exposure to the spread sectors of the market has been maintained closely to replicate the DEX Index. This has helped to insulate us against the turbulence. We do not own any maple bonds, broker bonds or asset backed securities, where much of the stress has been felt. Our bond management approach has always been to take advantage of short-term irregularities in the market, either through spread trades or yield curve trades. We will continue to maintain a conservative approach to the fixed income sector until we have a clearer view that the credit crisis is reaching an end.