

The BonaVista Quarterly

First Quarter 2009

Investment Strategy and Review

Faced with the worst global economic environment in 80 years, the markets worldwide have retraced back to levels not seen in numerous years. However, this is the environment we have been dealing with now for over 6 months. There is no new news here for the markets, only the residual onset of fear from time to time. From an investment perspective, it is time to envision a more robust economic outlook rising from the very large and various stimulus efforts being implemented by government and central bankers around the world.

Central banks interest rates are converging toward zero globally, further monetary stimulus in the form of money supply is being pumped up at historic rates and major fiscal stimulus plans are being put in place by most major economies globally.

These efforts will work to offset the very negative effects of the “toxic assets” which have brought down financial institutions worldwide and are at the root cause of the “credit freeze” that has gripped the world over the past year.

Targeted “bailout” plans to the bank, investment banks and other financial players, while slow at having meaningful effect are working and will continue to evolve until such time as the credit markets are improved and the financial sector is stabilized.

With so much negative news on a daily basis, one needs to look for the positive signs that things are getting better. The signs are there: spreads have improved, the commercial paper market seems to be functioning, intra-bank loans are flowing and mortgage rates are down. There is no doubt that we have a long way to go to get back to normal, but every journey begins with a first step.

On the economic front there is a lot of weakness, but here too there has been some scattered good news. Retail sales have been better than expected, housing inventory levels have declined and consumer confidence has lifted off the bottom.

From an asset mix point of view it is important to look forward not backward because stock markets are forward looking vehicles. The stock market typically anticipates an economic recovery six to nine months before there is any evidence of one. As we look at stock market valuations after the severe decline we’ve just experienced, we find valuations compelling. With markets trading at close to book value and single digit price/earnings ratios, these are levels not seen in a generation. Government bond yields have also seen generational lows. The 30-year US Treasury bond reached a 2.6% yield in December 2008 and has since seen the yield climb back to 3.7% (indicating prices have come down). We believe that on a forward basis stocks will outperform bonds and we have adjusted the asset mix of the portfolio to benefit from such a move.

Canadian Equities

During the quarter Canada’s major index, the S&P/TSX was among the best performing countries globally, but unfortunately still finished down slightly for quarter end. While starting the year strongly, fears of a deepening global recession coupled with declining commodity prices and lack of credit eventually weighted heavy on investor’s minds.

During the quarter, only three of the ten sub-sectors within the index generated positive returns – Information Technology, Materials and Healthcare. The Materials sector rose despite a decline in gold

and gold stocks because of a significant rebound in base metals. The portfolio benefited from being underweight gold during the quarter and, specifically, by not owning Barrick.

The sub-sectors that lagged the index during the quarter included Utilities, Industrials, Telecom, Consumer Discretionary and Financials. The Financial sector in particular was hurt by concerns that loan losses will continue to grow as Canada's economy contracts at its fastest rate since the 1960s.

During the quarter we added two new names to the portfolio: Gildan Activewear and UTS Energy. Gildan is a marketer and manufacturer of T-shirts, sports shirts, fleeces and socks. We were able to purchase Gildan in early March at multi-year lows and a compelling valuations.

We also added UTS Energy in late March at compelling valuations. UTS is a minority partner (20% interest) in the Fort Hills oil sands project along with Teck (20%) and Petro-Canada (60%). Under the terms of the partnership, Teck and Petro-Canada are responsible for the project costs on the first \$7.5 billion regardless of the total project size. We were able to purchase UTS at below replacement costs and at compelling valuations.

We also took advantage of the market's volatility to add to several existing positions including – Agrium, Bank of Nova, Canadian Natural Resources, Manulife Financial, Research in Motion, and Rogers Communications.

Finally, the portfolio benefited from its weighting in Petro-Canada as it is now in the process of being acquired by Suncor. The merger, which is expected to close September 2009, will create the fifth largest energy company in North America with a resource base of approximately 7.5 billion barrels of oil equivalent (boe) and an estimated resource base of approximately 19 billion boe. Furthermore, the combination of these two entities has a more balanced portfolio of assets with better growth prospects and a stronger balance sheet.

We continue to believe that despite the challenging economic environment globally the companies within the portfolio represent good quality and value and will generate superior long-term returns for investors.

US Equities

Unfortunately the U.S. market's downward trajectory continued into the first quarter and harkened back to Japan's "lost decade", with market levels touching lows not seen since 1996. However, near quarter-end the markets responded positively to the US government's \$1.2 trillion plan to ease credit markets by buying up Treasuries, troubled mortgages and agency debt. Despite this reprieve, which saw the U.S. market's best rally since 1987, the S&P500 finished down 8.4%. As disappointing as these returns have been, our increasing optimism stems from the fact that equity valuation levels are that their most attractive in approximately 25 years.

So far this year, all sectors of the market have retrenched, with the greatest declines being felt in the Industrials and Financial sectors. Both of these sectors have experienced significant earnings pressure, with certain Financials facing additional concerns over capitalization.

On the other end of the spectrum, the best returns originated from the Information Technology and Materials sectors. Several companies in the Materials sector benefited from signs of price stability in commodities such as copper and gold. In Information Technology, a number of companies boast cash-rich balance sheets and globally diversified business and revenue streams.

The U.S. Financial sector was the weakest performer over the past quarter and the past year and this overriding volatility created several opportunities to increase the quality of the portfolio. Within the sector, we took the opportunity to increase our holdings in Wells Fargo – a west coast bank that will thrive once the economy stabilizes – while eliminating our investment in Fifth Third Bancorp.

Also within the Financials sector, we reduced our holdings in Allstate, partially on account of quality concerns. The company continues to fare well in its core automotive business, but has experienced persistent deterioration within its fixed income investment portfolio.

Due to relative valuation, we reduced our holdings of Illinois Tool Works and Darden Restaurants. Both stocks had performed relatively well in a difficult market and we felt that there were more worthy investments available.

We added to our holdings in Dell as the company's near-term outlook appears challenged, but its financial performance remains solid. Over the past several years, Dell has lost market share to Hewlett-Packard, prompting the company to re-examine its reliance on the corporate market. The company is now rolling out its retail initiative in a very difficult environment. In response, Dell has mounted a very thorough cost-cutting program that is helping to maintain the company's margins. Its fortress-like, cash rich balance sheet is also a significant business advantage.

In this volatile period, we remain focused on identifying individual values that are arising to position the portfolio for superior long-term returns.

International Equities

The fund return in the first quarter was -7.6% versus a -12.3% return for the MSCI EAFE index. Although the market did not finish in positive territory for the quarter and tested new lows in February, the 5.4% return for the index in March was the highest monthly return in almost a year. This was a welcome sign to the international investor.

While the market continues to digest the impact of a globally stressed financial system and the resulting impact on the global economy, the continued coordinated efforts of governments around the world have produced some encouraging signs. The latest policy measures, including the toxic asset program set forth by the US Treasury, have had a positive impact on investor sentiment and commodity prices have started to stabilize. This has been a positive for the Energy and Materials sectors, which were the two best performing sectors for the quarter. However, despite the fact that the markets are as cheap as we have seen them in at least 25 years and we believe we are at or near the bottom, it may still take some time for markets and the economy to fully recover. As a result we continue to focus our portfolio holdings on companies with strong balance sheets, cash flows and other favourable quality measures to ensure that the portfolio will not only weather the storm but also capitalize during recovery.

The fund added significant value to the index largely through positive stock selection in Japan and from the positive contribution of emerging market holdings. Emerging markets were a bright spot during the quarter with a positive return of 2.9%, while developed countries saw every sector in negative territory, despite the strong close. Stock selection in the UK and Switzerland, as well as an underweight to Australia (which benefited from stabilizing commodity prices), were the major detractors of performance.

While currency was a large positive contributor to performance in 2008, it had a modest negative impact on performance during the first quarter. The Canadian dollar strengthened versus the euro, Japanese yen and Swiss franc, but weakened versus the US dollar and the British pound. As a result, the Canadian dollar return of the index lagged the local currency return by about 1%.

During the quarter, the fund made one new addition to the portfolio. Hoya is a global leader in the manufacture of mask blanks used in semiconductors and LCD panels. In addition to a strong record of profitability over the last 10 years, both in terms of margins 22% and ROE 18%, Hoya has a strong balance sheet with no net debt. Hoya was purchased at attractive valuation levels: a P/B of 1.7x and a normalized P/E of 11.5x.

Seven holdings were eliminated due to quality reasons. These included: Johnston Press, Anglo Irish Bank, Irish Life & Permanent, Lloyds Banking Group, Royal Bank of Scotland, Cemex, and OTE.

Bonds

After an uncertain start to the New Year, fixed income markets found their footing and upward price movement returned. The DEX Index was up 1.5% for the quarter, while our portfolio outperformed the index.

The US market posted mixed returns as the prospects of record budget deficits and Treasury funding requirements were digested. The Federal Reserve was on the sidelines with no further rate cuts at either of the meetings, stating the “economic conditions are likely to warrant exceptionally low levels of the federal funds for an extended period.”

The Bank of Canada continued its aggressive easing and cut rates a further 1%. It is expected that they will reduce the overnight rate by 25 basis points on April 21 from the current record-low of 0.50%.

Price volatility remained high as the bond market watched the equity markets closely for signs of improvement. New corporate issues were abundant signalling a spring thaw in the previously frozen credit markets. However, deals continued to be priced to sell and concessions to existing issues were still being paid. Several borrowers brought deals to market, which had been sidelined in 2008 when corporate spreads gapped wider.

Our portfolio continues to be just slightly over-weighted corporate versus the index. We added several new positions during the quarter, which included: Shaw Communications, Thomson Reuters and Manulife Financial. We sold our Telus bonds knowing that their prospects to bring a new issue at wider spreads were high.

Provincial issuance during the quarter was in line with expectations. Most provinces released their budgets with few surprises surrounding deficits. We initiated several trades in our portfolio taking advantage of the demand for longer maturity bonds. The portfolio is still overweight the sector but holds several shorter maturity issues.

The duration of the portfolio was allowed to drift longer as asset mix shifts flowed to equities. This enhanced the fund performance as bond prices improved. We have since scaled back and are neutral relative to the benchmark. Our focus now will be ensuring that we are positioned correctly on the yield curve to capture the end of central bank easing and the effects of their quantitative easing program.