The BonaVista Quarterly

Second Quarter 2007

Investment Strategy and Review

We have over the course of the past few years maintained a very positive outlook towards the equity markets and in particular towards the S&P/TSX. Our optimism stemmed from a view of robust global growth led by the rise of China and India in terms of contribution to the world economy.

Our investment stance has proven very rewarding as equity markets reacted positively to renewed global growth. With an emphasis on Canadian stocks we minimized the negative impact of the currency move on foreign returns. At this stage in the cycle it is prudent to reassess this position.

We view the global economy continuing its above average rate of growth over the investment horizon with China maintaining its leadership position.

Equity markets are fairly valued and well supported by strong fundamentals. We remain concerned that the fixed income markets are overvalued. While we don't anticipate much higher interest rates we believe spreads will deteriorate and returns from bonds overall will be minimal. As a result, we remain committed to our investment stance with a positive view on equity markets and a positive view on overall returns.

Canadian Equities

The portfolio outperformed the S&P/TSX during the quarter compared to the market. Likewise year to date the fund was ahead of the S&P/TSX. The fund benefited from a good exposure to both the Energy and the Materials sectors which led the market performance during the quarter as commodity prices remain at historically high levels. Stock selection added to returns as two of the holdings, Alcan and IPSCO, received takeover offers at significant premiums to previous trading levels.

Upward moves in interest rates have had a negative effect on Financial Services stocks. We do not believe that this is warranted as the credit cycle remains strong and Canadian banks and life insurance companies do not have large exposures to problem lending areas such as the sub-prime mortgage market.

Banks and Insurance companies are well positioned in Canada, have strong franchises, excellent balance sheets and high return on equity. These groups trade roughly at 12x earnings with 3.5% yield and have growing dividends. We feel the negative reaction to interest rates is temporary and are committed to the holdings in this sector.

During the quarter we added Lundin Mining to the portfolio. Lundin is a Canadian copper/zinc producer with operations in Portugal, Sweden and Ireland. The company is reasonably priced with growth opportunities from new mines still to come on stream within the next year. We like the company's exposure to base metals and the politically safe areas it operates in. Over time Lundin will grow to be a much bigger player in the mining area.

We also eliminated our position in Penn West holdings and increased the exposure to Nexen with the proceeds. We feel Nexen represents better value and has better growth opportunities.

The S&P/TSX, with its large resource base, has become more sensitive to the global economy. As world growth continues the S&P/TSX will prosper. At this stage in the cycle we feel the market represents fair value and is well supported by growth in earnings and cash flow. Strong balance sheets and ample liquidity worldwide will continue to fuel the takeover activity and may drive valuation forward. The portfolio is well diversified to take advantage of these trends and represents good value with exposure to high quality companies.

US Equities

The US portfolio outperformed the S&P 500 over the quarter, a period in which the US market did quite well, rising by 6.3% in U.S. dollar terms. Unfortunately, this was offset by continued strength in the Canadian dollar, which rose from approximately $0.87 per U.S. dollar to approximately $0.94 over the period. As a result, the Index actually declined 2.0% over the past three months in Canadian dollars.

Along with the strong performance, the S&P 500 reached a milestone in May – it finally equalled its peak level achieved during the technology bubble in March 2000. The composition of the index is decidedly different today than it was seven years ago, when all but three of its ten largest components were in the Information Technology sector. The current top ten is more diversified, and includes household names such as Procter & Gamble, AT&T and Pfizer.

We added two new holdings over the quarter (both large cap stocks), Motorola and Johnson & Johnson. Motorola is a leading manufacturer of telecommunications equipment, counting cell phones among its most important products, which are increasingly a fashion, rather than utilitarian purchase. However, Motorola has an excellent balance sheet and strong track record of innovation, and our more positive outlook prompted us to initiate a position in the company.

The second new position is Johnson & Johnson, which has recently been dealing with several issues. The company has an exceptional track record in growing its earnings and dividends on a per-share basis; it has an outstanding balance sheet; and is attractively priced, trading at its lowest relative valuation against the market in well over ten years.

We also increased our holdings of CDW, Dell and Progressive. The addition to CDW was particularly timely as soon after our purchase, the company accepted a buyout bid by a private equity firm at a generous valuation premium. Dell has made a number of changes since Michael Dell recently reassumed the role of CEO. He has already begun to improve customer service, refresh the product offering, and appears to be considering new methods of distribution in addition to the company's well-established direct-to-customer model. Dell's share price remains well below levels seen two years ago, and we see this as an attractive opportunity. Progressive announced a large one-time special dividend during the quarter and increased the rate of its share repurchases. While this was met with ambivalence by investors, we see it as a sign of continued capital discipline by management, and we are impressed by how the company can keep expanding while at the same time returning considerable cash to investors.

We reduced our exposure to Nokia, Aflac and Allstate due to price appreciation and for the same reason, we eliminated our investment in Procter & Gamble. Finally, we sold all of our shares of Alltel as the company accepted an offer from a private equity firm at the culmination of an extended operational review.

International Equities

Over the quarter the Canadian dollar was strong versus the majority of currencies resulting in a significant negative impact to returns to Canadian investors. Over the past year the Canadian dollar was strong versus the Japanese yen, Swiss franc and US dollar, but weak versus the British pound and the Euro. The net effect resulted in a small negative impact in Canadian dollar returns.

The portfolio underperformed the market during the quarter but maintained a significant lead over the one year period. Performance leadership internationally has come from Emerging markets as these countries have outpaced returns from EAFE over the past year.

Similar to markets worldwide the EAFE index has been led by performance of the economically sensitive sectors of Energy, Materials and Industrials. Likewise Financials have lagged in reaction to higher interest rates worldwide. The fund is overweighted in the best performing sectors and underweight Financials.

One new holding was added to the Fund in June: Misumi (Japan/Industrials). Misumi distributes precision machinery parts by catalogue and online. Its catalogue carries over 600,000 items including factory automation components, die components, cable and PC components for the electronics industry, optical devices, machine tools, medical supplies and food service supplies. The stock was purchased at a 2.9x P/B, 18.3x normalized P/E and a 1.1% dividend yield.

Bonds

The second quarter of 2007 presented several challenges for Canadian fixed income markets. Interest rates began to trend higher. The bull market in bonds would appear to have finally expired. The PCBond Universe Bond Index (formerly ScotiaCapital Universe Bond Index) reported a -1.7% return. Our portfolio's performance was in line with this for the quarter and year to date, fixed income returns are now negative.

Both the FOMC and the Bank of Canada continued to sit on the sidelines. Focus continues to be on the risk of high inflation. Turbulence in the US housing market may keep the Fed on hold for several more months. Treasuries should continue to trade side-ways during this period.

The Bank of Canada raised the overnight rate by 25 BPTS on July 10th. The Canadian economy remains on a steady but moderate growth path. However, Canadian dollar's continued strength should curtail any further action by the Bank of Canada, putting them back on the bench into 2008.

Several trades, which were initiated in the first quarter, to capture a slightly steeper yield curve, proved to enhance performance. As the yield curve became flat to inverted in shape, we sold some of our longer dated holdings (30 year Ontario's) to buy 10-year issues at a small give up in yield.

We participated in a new Manitoba issue, replacing our previous holding in shorter-dated Alberta treasury notes. Alberta notes were sold when they yielded less than identical term Federal agency bonds. Our portfolio is currently underweight this sector. If spreads move wider on the back of new supply, we will add to our exposure.

The corporate bond market provided investors with a huge challenge in Q2. LBO speculation first hit the Telecom sector before spreading quickly to other sectors including Retail, Pipelines and some Utilities. Our portfolio was not immune to this market action but the impact had only a small effect on the quarterly returns. A slightly underweight position in the corporate sector versus the index will be maintained. With Canadian yields trading well below the US corporates, the sector faces challenges.

We have not changed our outlook for returns by fixed income markets in 2007. The duration of the portfolio has been shortened relative to the benchmark. This profile, when coupled with our underweighting in spread product, is a conservative structure during the thinly traded markets of summer.