

The BonaVista Quarterly

Second Quarter 2008

Investment Strategy and Review

The collapse of Bear Stearns in mid March and the subsequent rescue package by the Federal Reserve and JP Morgan set the stage for a gradual easing of the credit squeeze in financial markets and a recovery in equity markets. While most of the equity markets in the OECD countries are still struggling in negative territory on a year to date basis, the S&P/TSX has benefited from a significant rise in commodity prices and leads the recovery with the best performance among developed countries. The collapse in the US housing market and the slowdown in economic activity appears to be coming to an end as recent economic data point to a fairly resilient consumer and a healthy corporate sector. Concerns about rising inflation expectations have put an end to any further easing for the time being by the Federal Reserve and the fixed income markets are looking ahead for the eventual beginning of a tightening cycle.

All of these cross-currents resulted in fairly volatile markets during the second quarter, which we anticipate continuing until such time as there is clear evidence of stronger economic growth ahead and a further improvement in credit availability.

While the S&P/TSX has been one of the best performing markets for the past few years, we anticipate this to continue, as global demand for commodities remains strong. We also anticipate a recovery in the economic growth from the US in the second half of the year, which should add to overall demand and support a recovery in equity markets more generally.

Canadian Equities

The Canadian equity fund generated a very healthy return in the second quarter but fell short of the market returns.

The fund lagged the S&P/TSX Composite Index due to negative stock selection during the quarter. While we like the stocks within our portfolio they did not perform well during the quarter. The fundamentals and the overall valuation of our portfolio of stocks keep us committed to our current strategy. We anticipate that with time we will regain the performance lost during the quarter.

Of the industry sectors that make up the S&P/TSX, Energy was the best performing during the first half of the year, followed by Materials. Financials, which until 2008 occupied the largest position in the Index, have underperformed the overall market and have fallen into second place behind Energy.

The portfolio benefited in the quarter from its robust allocation to energy and base-metal stocks, which have continued to gain ground on the back of rising commodity prices. Resource stocks have continued to make the S&P/TSX one of the developed world's best performing markets.

During the second quarter, we initiated holdings in two new companies, Quadra Mining Ltd., which gives us increased exposure to copper, and Stantec Inc., an engineering company which gives us exposure to infrastructure spending and an eventual recovery in the US economy. Both these companies have good potential prospects, are fairly valued and well managed.

We took profits in some of the energy stocks as the price of oil hit record highs. Long term oil and gas stocks still look attractive, but the move higher in such a short time warranted some profit taking. Within Energy, we initiated a small holding in Cameco, one of the world's largest producers of uranium. The company had experienced some difficulties bringing a new mine into development at Cigar Lake and the stock has underperformed. Longer term, the stocks will benefit as the problems at Cigar Lake are resolved and as the higher price of uranium gets priced into new contracts.

US Equities

The U.S. equity market lost ground in the quarter, with the S&P 500 declining by 2.8% in U.S. dollar terms and by 3.6% in Canadian dollar terms. Market sector performance varied widely, with the best returns coming from Energy (+17.3%) and Utilities (+8.0%) and the worst from Industrials (-10.1%) and Financials (-18.3%). Both Energy and Financials made headlines: oil reached \$140 per barrel in June after breaching the \$100 milestone earlier in the year, while Financials remained under pressure as credit conditions continued to deteriorate.

At this point, Energy and Financials represent extremes in the market. In Financials, the news has almost always been bad and stocks react with fresh declines. In Energy, it's the opposite. At the end of the last "energy market" in 1980, with oil price at \$40 per barrel, the weight of Energy stocks in the S&P 500 peaked at 32%. That same year, with the economy in the midst of a recession and interest rates near all-time highs, Financials represented just 5% of the Index.

Over the next number of years, the relative weights of the two sectors would flip. In October 2007, the Financials accounted for 22% of the market, while Energy troughed at 5% of the market in 1999. With the market's latest moves, the two groups now represent roughly 15% each of the S&P 500.

We continued to reduce our exposure in the Energy sector in the quarter, eliminating our holdings of Anadarko Petroleum and reducing our positions in ConocoPhillips and Nabors Industries.

Among the Financials, we reduced our AFLAC weighting, largely on the basis of the stock's strong performance and extended valuation. AFLAC is a remarkable health insurance company, but with the precipitous price declines in the shares of many companies within the Financials group, we felt that there were better relative values, particularly among the banks. Along that line, we added to our position in Wells Fargo and Progressive.

Wells Fargo remains the premier US bank, but has also suffered its share of credit-related losses, closing some of its mortgage origination channels. The company remains very well capitalized, however, and has indicated that it would be amenable to participating in a "US Federal Reserve-assisted" bailout of a troubled financial institution. We also added to our holdings of Progressive, the fourth-largest U.S. auto insurer. Weak underwriting performance in 2007 pressured the company's earnings, and its shares fell to half their 2006 peak. The company has addressed the issues in its insurance policy pricing and is beginning to see improvement in its results.

A couple of our Consumer Staples stocks held up quite well, Anheuser-Busch and Wal-Mart. We reduced our investment in Anheuser-Busch on the news that Belgian brewer InBev had made an all-cash offer to buy the company. We felt it was prudent to sell some of holdings at the elevated post-offer share price. We also reduced our Wal-Mart position on account of price appreciation.

The Consumer Discretionary group continues to weaken, burdened by higher energy prices and a faltering economy. We took advantage of the malaise and initiated a holding in Whirlpool, the world's leading manufacturer of household appliances. The company is consolidating that position with its 2006 acquisition of Maytag, a top competitor. Owing to record high commodity prices and a pullback in new home demand, near-term earnings have been under pressure. The stock represents excellent value and is an example of the opportunities that we are seeing in the market.

International Equities

The Fund return for the second quarter of 2008 was -6.4% versus a -2.8% return from MSCI EAFE. The underperformance for the quarter was attributable to stock selection in the U.K. and an overweighting in Ireland. This was partially offset by positive effects from the Fund's underweight position in France and its exposure to emerging markets. From a sector perspective, underperformance from stock selection in Consumer Discretionary, Materials, Industrials and Financials was partially offset by outperformance in Health Care. All country and sector exposures are a residual of our bottom up stock selection process. Year-to-date the Fund return was -8.6% versus the MSCI EAFE return of -7.8%. For the one year period,

the Fund return of -16.9% compared with a MSCI EAFE return of -13.9%. The underperformance over the one year period was attributable to stock selection in Australia and the U.K and an overweight position in Ireland. This was partially offset by outperformance in Japan and the Fund's emerging markets' exposure. From a sector perspective, underperformance due to stock selection in Consumer Discretionary, Materials and Industrials was partially offset by outperformance in Energy due to stock selection and underweight position relative to the Index in the Financials sector.

Equity markets produced negative returns over the quarter and one year period when measured in local currency and Canadian dollars, with the exception of the positive Pacific region return over the quarter, which can largely be attributed to Japan. Over the quarter and one year period, the Pacific region outperformed versus Europe. Emerging markets (MSCI EM Index) outperformed the EAFE Index over the quarter and one year period. Over the quarter, the Canadian dollar strengthened versus the majority of currencies. The net effect was a negative impact to returns in Canadian dollars as the EAFE Index reduced from -0.9% to -3.4%. Over the one year period, the Canadian dollar strengthened versus the U.S. dollar and British pound and weakened versus the euro, Japanese yen and Swiss franc. The net effect was a positive impact on returns to Canadian investors.

In sector terms, the standouts for the quarter were Energy and Materials, for their positive returns, while Financials, Consumer Staples and Consumer Discretionary produced the largest negative returns, as illustrated below. Over the one year period, the Materials and Energy sectors produced the highest positive returns in Canadian dollars, while the weakest performers, Financials and Consumer Discretionary, produced negative returns below -20%.

The Fund has a lower weighting than the EAFE benchmark in the Pacific and in Europe. Within the Pacific, the Fund has an underweight position in Japan. Within Europe, the Fund is underweight in the U.K., the largest country exposure in the Fund. Exposure to emerging markets was 14.0%.

During the second quarter, one new holding was added to the Fund: Rieter (Switzerland/Consumer Discretionary). Rieter has two separate businesses: textile machinery, for converting cotton and man-made fibres into yarn; and acoustics technology, which makes noise control products for the automotive and industrial sectors. The company produces its products throughout Europe and sells internationally. The stock was purchased at a 1.2x P/B, 10.5x normalized P/E and a 3.9% dividend yield. Four holdings were eliminated: Kurita Water (Japan/Industrials), Sangetsu (Japan/Consumer Discretionary), UBS (Switzerland/Financials) and Barratt Developments (U.K./Consumer Discretionary).

Bonds

Canadian fixed income markets gave up the strong performance from the beginning of the year reversing course in the second quarter of 2008 and resulting in negative returns. The DEX Index reported a negative 72 basis point performance. Our portfolio fared slightly better and was again ahead of the benchmark.

The Federal Reserve was less aggressive with its trend to lower rates and provided only one 25 basis point cut. The Fed Funds rate now sits at 2.00% and expectations are that the Fed is now on hold as they focus their attention on monitoring inflation.

The Bank of Canada cut rates 50 basis points in April and passed at the opportunity to cut again in June, much to the markets surprise. The bank rate is currently 3.00%. The Bank expressed concern that the strong Canadian dollar will not be enough to offset inflationary pressure in light of soaring commodity prices. They too will be monitoring for any inflationary signs over the coming months.

More companies from various industries came to raise capital in the bond market this quarter, however the largest issues continue to be from the financial services sector. The prices of these new bonds continue to come at wider spreads as demand for financial services paper has been saturated. Maple bonds (foreign debt denominated in Canadian dollars) issuance has virtually become non-existent in 2008 due to poor liquidity and the reduced demand resulting from lacklustre performance.

There were several trades done in the portfolio, which captured the shifting yield curve and enhanced the performance. The markets' anticipation of the next move from the Bank of Canada and then correction following their decision not to cut rates further provided much volatility in prices. Suncor came to the market with a new 10-year deal. We participated in the issue and sold some of our Sun Life Financial holdings in trade. Our position in BCE 4-year bonds was eliminated when a few buyers in the US provided bids in order to be able to add to their holdings. With the outcome of the Supreme Court ruling and the terms of the takeover now approved, that trade worked well for the portfolio and current markets prices are much below our sale level.

Our portfolio's structure has changed slightly since the end of the first quarter. We have added to our corporate sector weight, taking advantage of wide spreads. However, all of our new corporate bond purchases have been in the 10-year and under term to maturity basket thereby controlling risk. Our provincial weighting is now neutral to the index. We added a 5-year Alberta treasury issue. The duration of the portfolio has drifted to be marginally longer than the index. We will scale this back once the equity market gets its feet back on the ground and the flight to quality subsides.