

The BonaVista Quarterly

Second Quarter 2009

Investment Strategy and Review

The global recession brought about by the financial crisis will prove to be the second worst recession in history, outpaced only by the Great Depression of the early 1930's. By definition the global economies entered this recession beginning with the US in December 2007 and followed shortly thereafter by all other major economies. Using the US as a guide we are now in the 20th month of negative economic growth, which makes this the second longest recession, and in terms of magnitude is also the second most severe recession experienced globally.

So why are the equity markets up 40% from their lows of March? There are probably two main reasons that would explain this behaviour. Firstly, at the low point in March 2009, the markets were fearing (and pricing in) the possibility of another global economic depression similar to that experienced in the 30's. The massive co-ordinated effort by governments around the world helped provide liquidity to the market and managed to prevent going into the economic abyss. Secondly, the equity markets are forward looking and as such are factoring in the move towards better times ahead.

Equity markets typically anticipate an economic recovery by 6 to 9 months. In other words, if March 2009 was the bottom in stock prices we should see economic growth sometime this summer or at least before year-end. At this stage we view the economy as having stabilized, which is to say its not getting worse. We look for evidence of improvement and there are many data points which suggest there is some improvement. We recognize, however, the uncertainties and risks of a setback are also high.

At this stage in the economic cycle, it is always difficult to see how things can get better. Nonetheless, as cycle after cycle has shown, things do get better. We are of the belief that the worst is over and the road to recovery is ahead. We are not yet certain of how long that road is but the path is laid out.

Our portfolio is positioned to benefit from economic growth, and so far this year that has proven to be the correct stance. We remain cognizant of the fact that although the equity markets are up significantly, higher than they were at the bottom, they still remain roughly 30% lower than they were at the peak. Such devaluation is pricing in a significant recession.

Along with everyone else in the market we are hoping that the "green shoots" of spring start to flower in the summer!

Canadian Equities

The S&P/TSX, along with other major equity markets globally, staged a strong comeback during the second quarter. Our view is that the recovery from the lows seen earlier this year can be justified by having avoided economic disaster. We are seeing a recovery in Asia already and will likely see recovery in the US and Canada begin sometime this summer.

The S&P/TSX with its large exposure to commodities will benefit from economic growth and should continue to offer better upside potential than the US market. Over the quarter the best performing sector was Information Technology with heavy weight Research-in-Motion leading the charge. The largest sector in the market, Financial Services, was the second best performer, as the credit crisis abated and as it became clearer that the Canadian banks were in much better shape than other banks globally. This sector rebounded and finished up 32%. The Energy sector also put in a strong performance, up almost 21% as the price of oil more than doubled from its low.

The worst performing sector over the quarter was Telecommunications Services down 2.4%, usually viewed as defensive, it did not participate in the rally. Within the Materials sector the base metal stock were up 71%, but this was offset somewhat by a 5.6% decline in gold stocks leaving the sector on whole up only 4%.

Our portfolio benefited from stock selections during the quarter but also from an overweight in the better performing sectors and an underweight in the laggards. In particular, overweighting in banks and significant underweighting in gold stocks was a major contributor.

During the quarter we did not add any new position to the fund.

US Equities

The BonaVista US Equity Fund outperformed the market over a very strong quarter. The S&P 500's strength can be attributed to any number of factors that include: the impact of fiscal stimulus packages; low short-term interest rates orchestrated by the US Federal Reserve; government aid to specific sectors (most notably, the Financials); and, perhaps most importantly, outstanding share valuations.

Looking at the building blocks of performance, the June quarter was a mirror image of the first. Earlier in the year, the market's decline was led by the Industrials and Financials, which were the two leading groups in the second quarter. Continued strength was also noted in the Materials and Information Technology groups, as in the previous quarter. The weakest returns came from "defensive" sectors, such as Consumer Staples, Health Care, Telecommunications Services and Utilities.

Over the course of the year, the Financials have been the central story. It has been argued that the market could not make a sustained advance without stabilization in this sector and we believe that has been achieved. That is not to imply that we are out of the woods, or that financial shares will march consistently higher from here. We believe that the recognition of loan losses over the past eighteen months, sharp reductions in dividends, the completion of the government-mandated financial stress tests, a steep yield curve engineered in part by the US Federal Reserve, and plentiful capital raises have helped to establish a base for these companies.

We initiated an investment in Bank of America, while reducing our Wells Fargo holdings. Over the past year, Wells Fargo has outperformed most of its financial peers as well as the broader market. Bank of America has gone a long way to addressing their capital issues, and is trading at a very significant 50% discount to its book value – even after a number of dilutive stock sales and significant loan writedowns. We also reduced our exposure to two insurance holdings, Cincinnati Financial and Berkshire Hathaway. Both have outperformed most financial stocks but the best values are in the banking sector and we expect to position the portfolio to take advantage of this over coming quarters.

The Information Technology sector remains particularly attractive and we have a substantial overweighting in this group. We added to ScanSource, Microsoft, Intel and Dell. We reduced our holdings of Cisco Systems on account of price appreciation. Both Cisco Systems and Microsoft remain very substantial holdings in the portfolio. We will continue to look for opportunities in this area as the companies are generally very well capitalized, and trade at attractive levels due to the weakness in corporate technology spending.

We started a new position in Johnson Controls. The company operates in three areas, automotive seating, battery technology and commercial building controls. The weakness in the stock has been primarily due to the automotive group. As this sector recovers, we believe the value in the stock will be recognized. We also started a new investment in Burger King Holdings. Burger King has lowered profit expectations for the year, but continues to grow its earnings through the consumer slump.

We added incrementally to a number of established holdings, including Wesco and CarMax. Wesco is an electrical supplies distributor to a wide variety of customers, and expects to generate future growth from a combination of acquisitions and further development of their procurement services business. CarMax remains the leader in the used car sales business, with significant expansion potential.

We reduced our holdings of Illinois Tool Works and Johnson & Johnson as the stocks had outperformed and they were increasingly being priced at premium levels.

We eliminated our investments in Freeport McMoran and Whirlpool as the stocks had appreciated very substantially from the levels seen in earlier in the year, and better opportunities were available in stocks like AT&T and Brown & Brown, where we made small additions.

International Equities

During the quarter, international equity markets continued their strong gains from March, recovering almost 30% from the lows and pulling returns into positive territory for the quarter and the year. The fund's return in the second quarter of 2009 was +13.2% versus a +15.8% return for the MSCI EAFE index. As of June 2009, the year-to-date returns for the fund are 4.8% versus 2.7% for the MSCI EAFE.

The recent market rebound can be largely attributable to investors' confidence that the disaster scenario is now off the table, as measures taken by central banks and governments around the world have started to take effect and the markets look for better times ahead. Currency detracted slightly for the quarter, as the Canadian dollar appreciated against most major currencies (with the exception of the British pound), but was a relatively minor factor.

With this backdrop, all ten sectors in the MSCI EAFE Index had positive returns during the quarter. The best returns came from Financials (+30.3%), which have rebounded significantly from their lows as the threat of systemic bank failures has been somewhat abated by government actions, and Materials (+22.4%), which have seen many commodity prices rise significantly from recent lows. The worst performing sector was Healthcare (+3.0%).

The fund's underperformance for the quarter was attributable to stock selection in Japan and Hong Kong, which was partially offset by out performance attributable to stock selection in Ireland and the U.K. From a sector perspective, underperformance can be explained by an underweight position in Financials, although this was somewhat offset by stock selection in this sector. In addition, stock selection in Materials detracted from performance, while the Consumer Discretionary sector made a positive contribution for the quarter.

During the second quarter, one new holding was added to the fund. Richmond is a Swiss-based luxury goods company focused in the fields of jewellery, watch-making, writing instruments and other accessories. Concerns about discretionary consumption brought on by the credit crisis provided the opportunity to purchase Richmond at attractive valuation levels of P/B 1.7x and a normalized P/E of 13.9x. Also during the quarter one holding, United Utilities (a U.K. based provider of water and sewage services to Northwest England), was eliminated. The company's balance sheet weakened following a number of special payouts to shareholders and was eliminated for quality reasons.

Bonds

Canadian fixed income markets chose to ignore the headlines surrounding record government deficits and the potential for new issuance grinding prices higher. The DEX Index was up 1.2% for the quarter and 2.8% year to date. Our portfolio continues to outperform the index.

US treasury markets did not fare as well as investors chose to migrate to more risky asset classes. 10-year yields have risen from 2.10% in December- the lowest level since daily records began in 1962- to 4% by early June. The Federal Reserve remained on hold with rate cuts. Minutes from the FOMC meeting point out their concerns surrounding the weakening US dollar and the looming increase in Treasury bond supply.

The Bank of Canada met our expectations and cut its target rate to 0.25% in April. Rather than adopt a course of quantitative easing, as did the US and the UK, they chose to conditionally commit to keep rates low through the remainder of 2009.

Over the quarter corporate and provincial bonds outperformed Canadas along the yield curve. New corporate issuance continued to fall short of what we have seen in previous years, helping to draw spreads tighter. Buyers were anxious for industrial new issues or “anything but financials”. Ford Auto Securitization Trust completed the first ABS deal in the domestic market in almost a year. A light maturity calendar should keep refinancing activity quite low over the summer and new issuance will be modest. This will be a catalyst to tightening spreads.

Our corporate portfolio is slightly overweight versus the index. We participated in a few new issues but due to heavy investor demand our allocations were small.

Provincial spreads were slower to respond to improving economic conditions. Following the wrap up of budget season, questions remained unanswered about how some provinces would balance their books. Despite the concerns, what new supply did come to the market was easily digested as investors reached for higher yields, especially in longer dated issues. Our portfolio’s overweight in this sector was beneficial to our performance.

The duration of the portfolio is neutral to the index. However, our structure along the yield curve is quite different. We have positioned the portfolio with a view that as the economy improves the probability of a rate hike will rise and bond prices will come under pressure.