

# The BonaVista Quarterly

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## Third Quarter 2007

### Investment Strategy and Review

The markets experienced significant challenges during the third quarter of the year as a sudden repricing of credit-risk led to a world-wide liquidity crunch. A fairly co-ordinated easing of monetary policy by major central banks, including the Federal Reserve, provided much needed support and reassurance to the markets.

Our investment strategy has been quite positive over the past few years with a preference for stocks over bonds. Within the equity position we've favoured investing in our domestic market over foreign markets in order to take advantage of the resource exposure provided by the S&P/TSX and secondarily this helped reduce our exposure the currency moves.

We still feel this is the correct posture for this point in the cycle. Given the markets' unrest we anticipate further volatility in the coming months but expect that once the process of re-pricing risk subsides, liquidity will return. In the meantime, the global economy remains in good shape and equity markets are well supported by strong corporate fundamentals.

### Canadian Equities

Despite the turmoil experienced by world markets over the past few months as a result of the credit crunch emanating from the U.S., the S&P/TSX Composite Index did well for the quarter, gaining 2.0%. Although the portfolio fared well during the height of the sub-prime debacle, the Fund did underperform for the quarter. This was largely due to our lack of exposure to Research in Motion (RIM) and our underweight position in the gold sector, since we have felt for some time that both RIM and the gold sector are too expensive, given our focus on valuation metrics.

While the credit crunch put an end to much of the mergers-and-acquisition activity in the markets, the Fund benefited from the completion of the buyout of Aur Resources by Teck Cominco and the purchase of IPSCO by SSAB Svenskt Stal, a Swedish steel company.

The Fund also benefited from a takeover offer for Alcan by Rio Tinto, which was launched just prior to markets going into disarray in July. This deal is anticipated to close in October 2007, as the necessary financing is in place.

During the quarter we initiated three new positions in the portfolio:

Lundin Mining is a copper and zinc producer with assets primarily in Canada and Sweden. We like the metal exposure this company provides, as well as its growth prospects and reasonable valuation. With the stock trading at less than eight times the company's 2007 and 2008 earnings per share, we feel it is attractively priced.

Cognos provides business intelligence and corporate performance software. This is one of the larger Information Technology companies in Canada, with an excellent reputation and highly regarded portfolio of products. The stock trades at 18x the company's 2008 earnings per share, which is at the low end of its historical trading range.

Goldcorp is a Canadian gold producer with most of its assets in Canada, the U.S. and Mexico. We find the valuation of gold stocks challenging and we don't often get the opportunity to buy a large and growing producer such as Goldcorp at a reasonable valuation. This stock has lagged the market for some time, while the price of gold has increased. We purchased the stock at roughly 1.5x the company's book value per share, which leaves room for significant appreciation potential.

Overall, we continue to like the resource base in the S&P/TSX. We believe that world economic growth will remain robust, and that commodities will continue to be in demand. Stock valuations are reasonable for this point in the cycle. Market fundamentals are good with high single-digit earnings growth, strong balance sheets, and good cash flow – all of which give us comfort with the Canadian equity market.

## US Equities

The U.S. equity market was relatively flat over the quarter, rising 2.0% in spite of the ominous headlines surrounding the U.S. real estate and credit markets. Unfortunately, the US portfolio did not keep pace due to weakness in a number of consumer-related holdings.

The U.S. dollar has continued to decline against many international currencies and very notably against the Canadian dollar. This was further compounded by the Federal Reserve's decision to reduce the federal funds rate by 50 basis points in September, while the Bank of Canada held its key interest rate level. The U.S. equity market's return in Canadian dollars was (4.7)%.

While the overall market's return was relatively flat, there was a lot of variance between industry sectors in the quarter. Energy turned in the best returns, rising 9.8%, as oil reached a record price of over \$80 U.S. per barrel in September. Persistent strength in the global economy helped both the Materials and Industrials sectors, which gained 4.9% and 5.9%, respectively.

The weakest groups were Consumer Discretionary (down 6.3%) and Financials (down 4.3%). The decline in the U.S. residential real estate worsened over the quarter, raising fears of the first consumer-led recession since the early 1990s. At the same time, the credit market was in turmoil, led by the difficulties in both sub-prime lending and asset-backed commercial paper. As the risks associated with these troubles are difficult to quantify, the markets became gripped with fear, creating substantial volatility. In this environment, many companies offer outstanding value in their shares.

The US portfolio underperformed the S&P 500 over the quarter as a result of our overweighting in consumer related stocks. We added to a number of these stocks including Wal-Mart Stores and Comcast. Both of these stocks were pressured by concern over the level of consumer spending in the near term. There were several stocks, however, that declined for no discernable reason, such as Johnson & Johnson and Anheuser-Busch. These companies were punished indiscriminately by the market and offered excellent buying opportunities.

We reduced our exposure to a number of stocks that held up well in the period, including Berkshire Hathaway and Schering-Plough, both of which rose in the quarter. We eliminated four holdings: Bristol-Myers Squibb and Chesapeake Energy were eliminated due to valuation; First Horizon National was sold over quality concerns stemming from its mortgage exposure; and we sold CDW on account of its takeover by a private equity firm.

With the weakness in the financial stocks in August, we initiated a position in Cincinnati Financial, a regional property and casualty insurance company with a strong underwriting track record. The company places a strong emphasis on building its relationships with independent agencies in order to distribute its business and personal insurance products. Cincinnati Financial has a solid record of profitability and has increased its dividend for 47 consecutive years.

## International Equities

Over the quarter, the international fund was down (6.3)%, underperforming the performance of the EAFE index, which was down (4.2)%. Likewise for the year-to-date this portfolio has trailed the index. Much of the negative return however, is a result of the appreciation of the Canadian dollar versus the majority of world currencies.

The Fund's exposure to building related issues as well as financials, particularly in the UK and Ireland, were significant negative factors for performance. Building material suppliers, homebuilders and

financials all traded lower on heightened concern surrounding the health of the UK and Irish housing markets.

The weakness in housing related securities was felt in most markets around the world as the sub-prime mortgage issue in the US had ripple effects elsewhere. This presented opportunities to selectively add to positions in the Fund as valuations declined.

Two new holdings were added to the Fund in September. Omron (Japan/Information Technology), is a maker of electronic and industrial components with leading sensor and controllers technology, supplies parts for factory automation, consumer electronic and automotive usages. The second added holding is SMC (Japan/Industrial), which is the worlds largest manufacturer of pneumatic components. Both stocks were purchased at less than 2x book/value and 18x normalized price/earnings.

## Bonds

It was a volatile quarter for Canadian fixed income markets. Increased trading volumes replaced the usual doldrums of summer as investors digested the financial market headlines. The PCBond Universe Index reported a +1.7% return. Our portfolio's performance continues to keep pace with the index. Fixed income returns are once again up almost 1% on a year-to-date basis, exactly where we were at the end of Q1.

The Federal Reserve came off of the sidelines and cut both its target overnight rate and its discount rate 50 basis points in September. The reception from the treasury markets was mute, especially at the longer end of the yield curve as inflation concerns lingered. The Bank of Canada has yet to budge on current rate levels. With the CDN dollar trading above par slower growth prospects and tighter credit conditions might cause them to move to a more accommodative stance at either their meeting on October 18<sup>th</sup> or at latest by year-end.

Our portfolio's returns continue to be enhanced through our trading strategies within the provincial sector. We re-initiated our 10yr/30yr Ontario trade, which was unwound in Q2. This opportunity was presented as the yield curve once again steepened. The markets anticipation of a cut in rates by the Bank of Canada also provided us with trading opportunities in the shorter section of the curves as yields corrected their inversion in the 2 to 5 year maturities. We sold our 2-year Quebec Finance bonds to buy 3-year Canada agency bonds at a small pick up in yield. The portfolio is still underweight this sector. However, with credit spreads pushed wider over the quarter, this has been beneficial to our performance.

A new set of challenges for corporate bond investors were presented in Q3. Tremendous volatility in spreads was experienced across the corporate curve as headlines on sub-prime lenders and Asset Backed Commercial Paper (ABCP) defaults captured attention. The widening spreads initially concentrated on shorter maturities soon moved out the curve as investors realized that relative value adjustments were necessary. There are few positive signs for improvement in spreads near term as both banks and dealers try to reduce their inventories heading into their respective year-ends.

Our portfolio was not immune to these events. Fortunately, we do not own any ABCP. We still have not entered the Maple market, a sector that also was put under stress. Our telecom related issues, BCE and Telus, have seen a slight improvement in their trading levels as have other LBO candidates, such as Yellow Pages Group and Loblaws. We added a new position in Honda Canada Finance 5 years bonds when the issue was brought to market at historically wide spreads.

We are staying the course with our shorter duration profile into the fourth quarter. There is enough uncertainty about the timing and magnitude of the central bank rate adjustments, on both sides of the border to support this decision. Supply pressures and credit concerns will keep us underweight the spread product sectors of the market.