The BonaVista Quarterly
Third Quarter 2008

Investment Strategy and Review

History was made on Wall Street in September when the US financial system and, by extension, the global financial system, came to a grinding halt. With the failure of Lehman Brothers and the nationalization of AIG, Freddie Mac and Fannie Mae, fear spread through the markets, wreaking havoc on both equity and bond markets globally, causing the financial system to seize-up. Banks leery of other banks' ability to survive refused to lend to each other and inter-bank lending rates shot up to unprecedented levels in the wake of a crisis of confidence not seen since the Great Depression.

This situation threatened to spill over into the real economy where even credit worthy individuals and businesses would not be able to get financing. The danger to global growth from such a situation forced the US Treasury along with the US Federal Reserve, the US Securities and Exchange Commission, and central bankers worldwide to put measures in place both to stop the downward spiral of the markets and create some stability in the US mortgage market, where this mess began.

While it is still too early to know how well (and how quickly) these concerted efforts, along with global response, will work, we believe that the response is aimed at taking much of the risks out of the system and, as such, it is important to look beyond the storm when assessing the aftermath of the situation. The trillions of dollars that have been committed to fixing this problem will eventually work and add stimulus to the economy. In the longer term the US dollar will decline, and interest rates will go up.

At the same time, with the equity market retrenchment, stocks are discounting a global recession. While there certainly are a lot of risks out there, we feel it would be a mistake to be driven by fear and panic. The massive effort being exerted to unfreeze the credit markets will work with work with time. However, the longer credit is withdrawn from business, the more the effects will be felt in real economic activity. Nonetheless, we believe the Federal Reserve will be able to stabilize the system.

Canadian Equities

The Canadian equity market was the best performing market in the world up to the point when Lehman Brothers went bankrupt in September at which point massive liquidation of commodity positions and hedge funds took its toll on the S&P/TSX pushing down to levels more in line with what other markets around the world were experiencing. Performance was negative across all sectors year-to-date with Information Technology leading on the down side of 38% and Energy and Financials being the least impact, off about 11% to 12%. The one sector which one would expect should have performed during this period of uncertainty, should have been gold stocks. Yet even here there was no safety, as the sector fell 25% during the third quarter and 10% year-to-date. Much of the damage in the S&P/TSX has come from forced liquidation of funds. In these markets, fundamentals have not mattered and good value gets thrown out along with poor value. However, as markets settle down we are confident that fundamentals will re-assert themselves.

During the quarter, the fund benefited primarily from being underweight the Energy sector as oil dropped from a high of $148 to $100/bls. Also, during the first part of the quarter, the price of gold fell precipitously, bringing gold shares down with it, another sector where we have historically been underweight. During the quarter we eliminated our holding in CHC Helicopter. CHC was the subject of a takeover offer at $32 but we sold the stock into the market at $31 as we became concerned that the deal

might not be consummated given what was happening in the markets. CHC had been the subject of a failed takeover two years ago. We felt it prudent to "take the money".

Also during the quarter we initiated a position in Stantec Inc., Canada's largest publicly traded engineering company. The unique aspect of Stantec is that it has been profitable for every year for the past 50 years! This is a well-managed, well-diversified company with expertise in several key sectors of the economy. We initiated a position with the stock valued at 13x earnings, well below its historical valuation range. We also added a small position in RIM. While we have always liked RIM in the past, we have historically felt that RIM was too expensive given our value discipline. However as a result of substantial market declines, RIM became much more attractively valued.

US Equities

The US portfolio returned -3.3%, compared to -4.6% for the S&P 500. It was a very volatile quarter, led by the Financials, which registered a 14% drop, setting a low on July 15th (and that was after a 18% decline from March to June). From that point, the Financials staged an incredible rally, rising 31% to a peak on September 8th – the first day that Fannie Mae and Freddie Mac would trade as "wards of the state" – under the direct conservatorship of the US government.

Over the next two weeks, more news flowed – including the insolvency of Lehman Brothers, the shotgun marriage of Merrill Lynch and Bank of America and the government takeover of American International Group (AIG). The US Federal Reserve responded with substantial liquidity injections, explicit support for securities in beleaguered money market funds and the creation of "Resolution Trust 2", a facility that will enable "bad" loans to be sold to the government to provide liquidity to domestic financial balance sheets.

It was an unbelievable sequence of events that marked the greatest level of government intervention in the US capital markets since the Great Depression.

The volatility of the US markets was very pronounced over the past three months, giving us a number of opportunities to add back to positions that we had previously trimmed.

One example was Aflac, a stock that we had reduced last quarter, as the shares had been immune to the weakness in the Financials. Upon reporting their second quarter results, the shares fell sharply over concern that sales had grown at a fairly slow pace in both the United States and Japan and we added further to our position.

Another example was XTO Energy, a stock that we reduced late in the second quarter when the price of natural gas was $14 and oil was trading at $140. The company has an outstanding record of increasing its production and reserves by 20% annually for the past twenty years. The rapid decline of energy prices over the past three months provided us with an opportunity to add back to XTO Energy at a price that was 30% below our previous sale.

We initiated a position in FMC Technologies, a leading company in the oil service industry. Most of the world's new oil finds located in hostile environments, and particularly in deep water. FMC holds a leading share of the subsea well completion market, and is introducing new technologies that will differentiate the company's offerings further from their competitors.

On account of price appreciation, we reduced our holdings of Johnson & Johnson and JB Hunt Transport Services. Johnson & Johnson is one of the most diversified companies in the Health Care sector, with an exemplary record of long-term growth. JB Hunt is a leading trucking company with a significant portion of its profits generated from intermodal business with railroads such as Norfolk Southern and Burlington Northern. Both stocks have done very well over the past year, providing us with an opportunity to redeploy the proceeds in stocks offering better value, such as Microsoft.

Microsoft shares peaked late in 1999 at $60, participating along with many other companies in the technology bubble. The company is maintaining a dominant market share in PC operating systems, while trying to build up its online presence as a counter to successful companies such as Google. Looking back

over the past eight years, the company has consistently grown its earnings by a factor of 2.5X, while its shares have declined by almost 60% providing us with an excellent contrarian opportunity.

We also added to Zebra Technologies, a manufacturer of printers for the barcode and personal ID applications.

The US market has been through an unprecedented period of volatility, one that we expect will continue. We intend to use this unpredictability to add to and initiate positions in some of the highest quality companies in the US market at prices that we haven't seen in many, many years.

International Equities

The fund return in the third quarter was -13.0% versus a -17.3% return from MSCI EAFE. The outperformance for the quarter was attributable to stock selection in the UK, Hong Kong, Japan and Switzerland and positive contribution from the fund's emerging market exposure. This was partially offset by a negative contribution from an overweight position in Ireland. From a sector perspective, the fund outperformed due to stock selection in Industrials, Materials, Consumer Discretionary, Utilities and Telecommunication Services. This was partially offset by underperformance primarily due to stock selection in the Financials sector. Over the quarter, the Canadian dollar strengthened versus the euro, the British pound and the Swiss franc and weakened versus the US dollar and Japanese yen. The net effect was a negative impact to returns in Canadian dollars as the EAFE Index reduced from -13.0% in local currencies to -17.3% in Canadian dollars.

Over the quarter, Europe (-11.3%) outperformed the Pacific region (-16.6%) when measured in local currencies. When translated into Canadian dollars the Pacific region (-16.3%) outperformed Europe (-17.0%). In the developed markets, the US (-4.8%) and Switzerland (-9.1%) were the best performing countries, while Ireland (-39.4%), Austria (-38.4%) and Norway (-37.8%) had the largest declines. Emerging markets (-23.5%) significantly underperformed versus EAFE over the quarter.

All ten of the sectors in the MSCI EAFE Index had negative returns for the quarter. The sectors with the best returns were Health Care (-3.7%) and Consumer Staples (-4.8%). The sectors with the weakest returns were Materials (-27.2%), Energy (-27.2%) and Industrials (-21.1%). In sector terms, the fund is most significantly different to the benchmark by being overweight in Consumer Discretionary and Industrials and underweight in Financials and Consumer Staples. 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 UK, the largest country exposure in the fund. Exposure to emerging markets was 14.2%.

There was one new holding added to the fund during the third quarter. Keyence is a specialist manufacturer of sensors and measuring equipment for factory automation. It has dominant market shares in over 60% of its products. Return on equity has averaged 13% over the last 10 years, despite a large proportion of assets being invested in cash and investments (currently 75%). Concern over economic weakness, and therefore capital spending, created an opportunity to invest in Keyence at P/B of 2.1x and a normalized P/E of 16.5x.

Two holdings were eliminated during the quarter. Prosafe was split into two separate companies with Prosafe retaining the accommodation business and Prosafe Production representing the FPSO business. Prosafe also retained most of the debt and its balance sheet became highly leveraged. It was eliminated for quality reasons at P/B of 8.7x and normalized P/E of 17.3x. Heidelberger Druck was also eliminated for quality reasons. While it remains the dominant leader in the offset printing machinery industry in both market share and technology, its profitability has suffered from digital competition, and unprofitable expansion into post-press (including packaging) machinery, and a high cost base in Germany. It was sold for quality reasons despite a low valuation level at a P/B of 0.9x and a normalized P/E of 8.1x.

Bonds

Fixed income markets fluctuated wildly during the third quarter. After two months of positive returns, driven by the flight to quality to bonds from equities, there was a sharp about face in September. The DEX Index reported a -37 basis point return. Our portfolio was very close to this reporting -45 basis points and is still ahead year-to-date.

The yield curve in the US market experience extreme volatility as 90-day Treasury yields sank to their lowest levels since 1955. The run to safety was so drastic in the US Treasury Department concluded that it was necessary to temporarily guarantee US money market funds.

The Bank of Canada's tome became a little more dovish as volatility in bond prices intensified. However, the volatility in the Canadian bond market remains relatively tame in contrast to the US market. The odds of a Bank of Canada rate cut appeared to be building based on weak economic releases as well a liquidity and market confidence pressures.

Trading in the portfolios was relatively light over the quarter, as liquidity seemed to decrease with each passing week. This was particularly true in corporate, provincial and even government agency bond issues. Most of our trading was focused on catching the flattening and steepening of the 5-20 year area of the yield curve.

Spreads on all sectors of the bond market traded wider. Even spreads on fully guaranteed 5-year agency issues widened 15 basis points in September. The spread is now at 70 basis points. This time last year the spread was 22.

Ongoing market turmoil has meant relatively little new issuance in the provincial sector. Secondary provincial spreads have trended wider in sympathy with wider credit spreads in all markets.

New corporate deals continue to offer extraordinary concessions in spreads relative to existing issues. One example of this was seen with the new issuance by American Honda Finance. Their new 5-year deal is at 125 basis points higher than existing issues. This forced a re-pricing of existing debt.

While not completely insulated from the market problems, our conservative investment approach has kept the portfolio out of harms way in the most troubled parts of the market. We have not owned any Maple issues or broker issues. The corporate sector weighting is very close to that of the DEX Index. The same is true for our Provincial sector weight. Although we are overweight the government agency issues, we recognize that these issues are fully guaranteed by the federal governments. These are simply a victim of circumstance in the current environment and will outperform when the correction comes. With our neutral duration profile and conservative management style we will weather the current market conditions.