

The BonaVista Quarterly

Fourth Quarter 2007

Investment Strategy and Review

What started out as a perfectly fine year for the markets turned into an exceptionally difficult one by the end. Optimism over the strength of global economic activity could not overcome the concern emanating from the credit crunch experienced throughout the OECD countries.

Plummeting housing prices in the US led to a sub-prime mortgage crisis, which quickly developed into a major liquidity squeeze that spread to all markets. A rescue mission led by the Federal Reserve in the form of lower interest rates and massive injections of temporary loans to the banking system, was not swift enough nor decisive enough to convince the markets that the damage could be contained. As a result in the latter part of the year, the equity markets sold off world wide, in many cases undoing the performance achieved in the better part of the year.

The S&P/TSX, with its high exposure to resources, outperformed most markets around the world. Returns from foreign markets were negative after factoring in the significant move in the Canadian dollar.

We are not convinced that an economic recession in the US is a sure thing, however, a slowdown in economic activity is currently underway. Global economic activity is in good shape with growth at an above average pace and increasing demand for basic materials, oils and foods will continue unabated.

We invest for the long run. Our strategy to be overweight in Canada over the past 5 years has worked well for us. We anticipate further volatility in the months ahead, but view the longer run positively. Equity markets are better priced than fixed income markets and we remain committed to our strategy.

Canadian Equities

The S&P/TSX, while one of the better performing markets in the world last year, was itself particularly challenging. Only 36% of the stocks outperformed the market and that understates the narrowness of the advanced as two stocks (Research In Motion and Potash Corp.) accounted for over half the market's price appreciation. We have historically not owned either of these two stocks as their valuation metrics put them outside of our comfort zone given our value style.

A general observation indicates that in the later part of the year markets became very growth oriented. "Growth" stocks outperformed "value" stocks by a significant margin for the first time in several years. As a value manager, our portfolio did not have exposure to these stocks, which resulted in the portfolio underperforming the market for the first time in nine years.

Over the year, the Fund benefited from takeover activity within the portfolio, and even though mergers and acquisitions were severely curtailed in the second half of 2007, we were able to benefit late in the fourth quarter from the takeover of Cognos by IBM. We had purchased Cognos in the third quarter, so this holding proved to be short-lived but quite profitable. During the fourth quarter the takeover of Alcan by Rio Tinto was also completed. We used the proceeds from those transactions to add several new companies to the portfolio.

In the Industrials sector we added Finning International, which is the world's largest distributor of Caterpillar machinery. This is a very well run company with an exceptional track record. It is a prime beneficiary of Canada's increased mining activity, including the oil sands, where it supplies very large and complex equipment. Finning offers indirect exposure to the global natural resources boom, and at its current share price it represents good value.

In place of Alcan, we added several new mining stocks: Inmet Mining, Lundin Mining, Polaris Minerals, Uranium One and Yamana Gold. This group of companies was purchased at inexpensive valuations. The aim of this approach is to maintain exposure to a variety of metals through companies that offer growing production and a reasonable cost base.

Looking ahead, we anticipate further market volatility in the coming months but feel that the overall market valuation is reasonable. We continue to expect that economic growth will run above trend rates in 2008, even as the U.S. economy slows. As liquidity comes back to the markets, stocks should perform well, particularly in the latter half of the year.

US Equities

The U.S. equity market was weak over the quarter, losing 3.3% (in US dollars) as headlines highlighted the difficulties in residential real estate and the banking system. The US Federal Reserve stepped in on a number of fronts, lowering the Fed Funds Rate by 0.25% and engaging coordinated action policy among international central banks, including the Bank of Canada. Over the short term, the market's reaction has been lukewarm to these initiatives, with ongoing downward pressure on stock prices in the wake of the announcement.

The BonaVista US Equity portfolio underperformed the market over the quarter, largely due to softness in Consumer Discretionary and Industrial stocks that were sensitive to a weaker consumer and slowing economy. Notable weakness was evident in Comcast, Illinois Tool Works and Gannett. The Financial stocks were able to offset some of the underperformance with particularly strong gains from Berkshire Hathaway and Aflac.

The Financials sector was an area of focus during recent months. We eliminated two holdings, American International Group and Citigroup, on account of the risks associated with their investment in some subprime-related securities. American International Group has substantial exposure to CDO-related securities and while the company has indicated that their holdings are of superior quality, we decided to sell our holdings and wait for a more attractive valuation point. With Citigroup, its subprime investments had experienced significant declines that in combination with other factors, weakened their capital structure to the point where we felt that there were better investment alternatives in other banks with superior balance sheets, such as Wells Fargo.

Wells Fargo is one of the largest US banks, and it also has the distinction of having among the most conservative lending practices. While the difficulties in the US mortgage and real estate markets impact almost all financial services companies, Wells Fargo will have the chance to gain substantial future market share at the expense of their capital-impaired competitors.

Other transactions among the Financials included a reduction in both Commerce Bancorp, which is being taken over by Canada's TD Bank, and Aflac, one of the strong performers mentioned previously. In both of these instances, the stocks had appreciated to the point where there we found better investment alternatives in companies like General Electric and Nabors Industries.

We also sold our position in Liz Claiborne during the quarter, after reassessment of the company's prospects. We view the company's new management positively, but Liz Claiborne is undergoing a restructuring that might take longer than investors currently expect. Subsequent to our sale, the shares have dropped fairly substantially – down approximately 50% - and if this decline continues, expect us to reconsider an investment in this company, but for now, we are happy to watch from the sidelines.

International Equities

For the one year period, the Fund return of -10.0% compared with a MSCI EAFE return of -5.7%. The Fund underperformance in the U.K., Germany and Ireland was partially offset by outperformance in Japan and Holland and a positive contribution from the Fund's emerging market exposure. From a sector perspective, the Funds underperformance in Consumer Discretionary, Industrials and Materials was partially offset by outperformance in the Energy sector.

Equity markets produced negative returns over the quarter when measured in local currency and Canadian dollars, with the exception of the emerging markets. Over the one year period, equity markets produced a mix of positive and negative returns when measured in local currency and Canadian dollars. Over the year, Europe outperformed versus the Pacific region and Emerging markets (MSCI EM Index) significantly outperformed the EAFE Index.

The Fund continues to have a lower weighting than the EAFE benchmark in the Pacific and in Europe. Within the Pacific, the Fund remains significantly underweight in Japan. Within Europe, the Fund is overweight in the U.K., the largest country exposure in the Fund. Exposure to emerging markets (non-EAFE markets) was 14.5%. Cash was 4.6%.

In sector terms, the Fund is most significantly different to the benchmark by being overweight in Consumer Discretionary and Energy and underweight in Consumer Staples, Financials, Information Technology and Utilities.

In sector terms, the standout over the year was Materials, with a return in excess of 10% in Canadian dollars, while the weakest performers, Financials, Health Care and Consumer Discretionary, produced negative returns in excess of 10%.

There were no new holdings added to the Fund and three were eliminated during the fourth quarter. ABN Amro was eliminated as a result of a takeover by a consortium led by the Royal Bank of Scotland, another holding of the Fund. The Fund received cash and shares of Royal Bank of Scotland as part of the takeover agreement. The cash was used to increase the Fund's position in a number of names. Maruichi Steel Tube was eliminated for valuation reasons. Taisho Pharmaceutical was eliminated for quality and valuation reasons. There were a number of additions to existing holdings at attractive valuation levels, including several in the Industrials, Consumer Discretionary and Financials sectors. Similar to the third quarter, this meant adding to housing-related and financial holdings in Ireland and the U.K. where share prices have reacted to uncertainty in the housing and credit markets. These include Grafton, Wolseley, Barratt Developments, Travis Perkins, Allied Irish Banks, Anglo Irish Bank, Royal Bank of Scotland and HSBC. A number of holdings were reduced for valuation reasons, particularly in the Materials sector.

Bonds

Canadian fixed income markets traded higher in price during the final quarter of 2007 with each month posting positive returns. The DEX Index (new name of PCBond Universe Index) reported a +2.75% return. Our portfolio's performance kept pace with the index to end the year. For the year, the index was up 3.7%.

The Federal Reserve once again tried to calm the nervous markets with liquidity injections and two modest 25 basis point cuts in the Fed Funds rate. The market's reaction was one of too little too late.

The Bank of Canada also cut rates in December by 25 basis points, acknowledging that the downside risk to world economic growth had increased. This elicited a positive reaction from the bond market.

Trading activity in the portfolio during the final quarter was focused on two themes: capturing the positive tone in the bond market and avoiding the unravelling of corporate spreads. We were successful on both fronts. The duration of the portfolio drifted longer, the result of our selling bonds with maturities in 2008, and purchasing corporate issues with 2.5 years to maturity.

Two corporate positions, which we had been monitoring closely since the 3rd quarter report, were sold. Our long Loblaw's bonds and 10 year Yellow Pages Group had shown slight improvements in their trading spreads. The sales of these positions added to the positive performance of the portfolio as spreads deteriorated into year end.

There are few factors currently visible in the spread sector of the bond market to encourage us to increase our exposure. Although, spreads appear historically wide, a heavy 2008 maturity schedule and strong loan growth will lead to lots of supply over the years. In an environment where new issue concessions

continue to put pressure on credit spreads, there is no rush to buy. We expect a better buying opportunity by mid year.

At this time we are neutral to the DEX weightings in both the provincial and corporate sectors. However, our duration in these sectors is much shorter thereby reducing our risk. The portfolio duration will be scaled back to neutral when the equity markets finally get stable. Our management style is not to take risk in this asset class. This style has proven true for us.