The BonaVista Quarterly

Fourth Quarter 2008

Investment Strategy and Review

There are many dire descriptions of the year 2008, which was in many ways the worst year since the Great Depression, but at the heart of the matter, it was the year when "greed and fear" finally met on Wall Street.

The consequences of that meeting rippled through financial markets worldwide and will affect the world economy for years to come. While there are many examples of both "greed and fear" to choose from, the predominant ones on the "greed" side included the sub-prime mortgage market which will eventually result in trillions of dollars of losses. On the "fear" side we can look to the complete freeze up of the credit markets worldwide and the resulting collapse of financial institutions globally.

It was a disastrous year, and it was global in nature affecting every asset class. The fallout from the Lehman Brothers collapse in mid-September has been severe. This failure set in motion a series of events which caused an unprecedented credit freeze and set Wall Street firms and major banks around the world tumbling one after the other.

The economic consequences of this freeze are yet to be tallied but can be glimpsed in the rapid decline in industrial production, world trade and the increase in unemployment. While there is evidence that credit between banks is normalizing, this has not yet spread to the broader markets. It will take time for confidence to be restored and markets to return to "normal".

Unprecedented government intervention, both in the form of lower interest rates, but more importantly, in unconventional support to the credit markets has begun to stabilize the situation. We anticipate the next move by government of direct injections into the economy through massive fiscal stimulus will provide the energy needed to move the economy and markets back towards positive growth.

Another consequence of the credit freeze has been the forced unravelling of leveraged trades within the banking system and the hedge fund industry. This unwinding of leverage has been accomplished through what we will call "consequential moves":

1. selling of equities, causing prices to collapse
2. buying US dollars, pushing the US dollar up in value
3. risk aversion, causing long US treasuries to trade at the lowest yield in modern history
4. short term T-Bills traded momentarily at negative yields

It is our view that once these "forced" trades come to an end, markets "normalize" and risk aversion subsides, these "consequential moves" will begin to reverse. Stocks should recover, the US dollar will decline and treasury yields will rise, as the need to pay for the deficit will require higher interest rates.

Most stock markets around the world declined 40% to 50% from their highs, discounting a severe global recession, and are at historically low valuations when compared on many conventional metrics. We continue to believe that as credit unfreezes and fear subsides, the opportunity for significant returns from stocks exists.

On that front, we are seeing improvement in key indicators of credit availability, which clearly show that effort by central banks and the Fed in particular are beginning to work. This will be the first step in the recovery. It will be a process and it will take time for the world to right itself. Eventually this will lead to markets recovering and confidence being restored.

Canadian Equities

After holding up quite well for most of the year, the S&P/TSX succumbed to the turmoil in the financial markets worldwide and the prospect of slower global growth.

The heavy weighting of resource stocks had a significantly negative effect on overall performance as commodity prices collapsed during the quarter. Likewise nervousness on the credit side coupled with rising funding costs weighed heavily on the very large financial sector of the market during this same period.

For the quarter financial stocks in the S&P/TSX were the worst performing sector of the market. Both the banks as well as the major life insurance companies came to the market to raise equity and bolster their balance sheet as stakeholders encouraged strengthening equity positions in these uncertain times. The resource sectors of the market all suffered large downgrades with the exception of gold stocks, as commodity prices declined and risk aversion increased.

The global view of commodities which only a few months ago, was one of looming shortages, changed quickly to one of oversupply in a failing economic environment. During the quarter, we have seen a significant supply response and major shutdowns have been announced across the board by companies. These production curtailments along with construction deferrals and mine closures will result in supply shrinking and prices stabilizing. The markets will eventually look through this economic downturn to the next period of economic growth and conclude that demand will not be met by new supply and prices will recover over time.

During the quarter, we did not add any new names to the portfolio, but did average down on several existing holdings as stock prices came down. Included among these were Suncor, Agrium, Gerdau Armeristeel, Bank of Montreal and Husky Energy among others.

While the economic environment is difficult there is pervasive pessimism about the future priced into the market. Historically we reach a point where the markets have priced in the bad news and look forward to better times. We feel that we are at that point. Markets are forward looking and we anticipate an upward movement in stock prices before we see an upward movement in economic growth.

US Equities

The US market turned in its worst quarter since the infamous crash of October 1987. A key difference between then and now is that in 1987, the S&P500 was actually up a small amount for the year (in US dollars), while this year the market declined by 24%.

Each of the ten market sectors has generated negative returns over both the quarter and past year. The broad-based nature of the decline is emphasized when only thirty-eight stocks in the S&P500 were able to produce a positive return for the full year!

Through all of the doom and gloom, there is a silver lining. The valuation of the US equity market is now trading at the lowest level we have seen over the past thirty years, or more.

The S&P500 was down 37% in 2008, but in Canadian dollars was down a smaller 22%. Our fund outperformed over the course of the year.

The volatility witnessed in stock markets was also seen in commodities. The oil price peaked in July at $146 and has since declined to its current level of $48 – the sharpest retreat ever seen. Amid the dislocation, we adjusted some of our energy holdings, making a small reduction in our holdings of ConocoPhillips and eliminating a minor position in Marathon Oil in order to initiate a position in ExxonMobil. ExxonMobil is the largest company within the S&P500, but trades at a very reasonable level of 10.6x normalized earnings, with $38 billion in cash on its balance sheet. We also added to our holdings of FMC Technologies, Nabors Industries and XTO Energy.

Shares of financial stocks were particularly depressed at certain points in the quarter, including General Electric (with its GE Capital Services division) and Berkshire Hathaway. We trimmed our position in General Electric to add to Berkshire Hathaway, which was trading at a twenty year valuation low at a 10% premium to book value.

The market decline has presented us with a chance to reassess the relative merits of a number of holdings. As part of this review, we have eliminated positions in Kenneth Cole Productions and Leggett & Platt, and reduced exposure to JB Hunt Transport Services. Of those names, only JB Hunt was sold on account of valuation. The remaining names were no longer attractive investment owing to declining business fundamentals.

Taking advantage of the valuation disparities, we initiated a position in Norfolk Southern, a leader among US-based railroads on an operating rate basis. The company has a good mix of steady demand products to haul like coal, chemicals and paper/forest products and is increasingly exposed to faster growth areas like intermodal. We also added to existing holdings of Aflac and Cisco Systems.

International Equities

The fund return in the fourth quarter was -9.7% versus a -7.4% return from the MSCI EAFE index. Over the year, the fund returned -28.1% versus -29.4% for MSCI EAFE. The fund underperformed for the quarter largely due to negative stock selection in the UK and a negative contribution from the emerging market holdings. Outperformance over the year was primarily attributable to stock selection in Japan, Switzerland and Hong Kong.

There were few bright spots in international equities in 2008, as markets around the world tumbled 40% to 50% from their highs. In fact, of the countries included in the EAFE Index, the UK was the best performing in 2008 in local currency terms with a return of -28.5% – hardly worth celebrating. The only positive from a performance perspective was the impact of currency, which helped performance over both the quarter and the year, as the Canadian dollar depreciated versus most major currencies (with the exception of the UK pound). This impact was significant, as local currency returns lagged the Canadian dollar returns by approximately 10% over the quarter (-18.5% vs. -9.7%) and the year (-40.3% vs. -29.4%).

On a sector basis, few sectors were able to escape negative returns over the year. Even with the positive impact of the depreciating Canadian dollar, only the Health Care sector (1.4%) had a positive return in 2008. The Financials (-44.0%) and Materials (-41.2%) sectors were hurt the most as the combination of the financial crisis and a global slowdown which resulted in commodity price declines weighed heavily on these sectors. Over the quarter, while four of the ten sectors had positive returns, this was largely the result of currency. The Financials (-21.5%) and Materials (-14.8%) sectors were the worst performing sectors for the quarter.

Through this market turmoil, the fund has made several changes. Seven holdings were eliminated in the quarter. These included Prosafe Production, Acerinox, DSG International, OTP Bank and Telmex International, which were eliminated due to quality concerns and Diageo and Novo Nordisk, which were eliminated for valuation reasons.

In addition, we added four new holdings to the fund during the quarter. Sin-Etsu Chemical divides its business into three segments: organic and inorganic chemicals, electronic materials and functional materials (synthetic quartz). It is a global leader in PVC, silicones and in electronic materials and is a market leader in silicon wafers. It was purchased at a P/B of 1.1x and a normalized P/E of 12.0x. Fanuc, which manufactures factory automation systems and equipment and industrial robots was also added. It was purchased at a P/B of 1.3x and a normalized P/E of 12.1x. Finally, Tesco (a U.K. based food retailer with a growing global presence) and Hirose Electric (which develops and sells electronic components, specializing in connectors) were also added to the portfolio. They were added at P/B of 2.0x and 1.1x respectively and a normalized P/E of 13.4x and 11.5x respectively.

Bonds

The final quarter of 2008 presented fixed income markets with new challenges. The flight to quality resumed in November and December, fuelled by the credit freeze and economic uncertainty. The DEX Index reported a 4.5% return. For the year 2008 the DEX was up 6.41%. Our portfolio outperformed the index.

The yield curve in the US market steepened further as the Federal Reserve cut rates 175 basis points. Treasury bill yields fell to offer investors close to zero as a return. However, given the uncertainty of corporate bonds and equity markets, the buyers were not deterred.

The Bank of Canada followed suit with the Fed and by the end of the quarter the bank rate was half what it had been at the beginning of the period.

Although there were days of extreme volatility in bond prices our trading was kept to a minimum. The focus remained on avoiding the pitfalls of the corporate bond market and capturing changes in the yield curve.

Spreads on all sectors of the bond market continued to trade wider despite very little new issuance. Spreads on corporates were re-aligned as investors disregarded ratings and focused more on the nature of the business. Since financial bonds represent more than half of the Canadian corporate market, heavy selling in these large liquid issues added to spread widening. Utility bonds came under pressure due to expectations of heavier issuance to fund capital spending. The infrastructure segment (airports, highways and ferry services) was the best performing group despite concerns surrounding high fuel costs and the impact on travel.

Our portfolio closed the year with a small overweight in the corporate sector of the index. We did eliminate our positions in Suncor and General Electric Funding Canada and although the spreads at the time of sale seemed wide, by year-end they were trading wider.

The provincial and municipal holdings in the portfolio remained fairly constant. A few trades were initiated to capture changes in the yield curve and relative spread movement between provinces. Issuance has been very light but will increase early in the year. Spreads on provincial bonds tested their historical wide levels in December and new supply could easily push us back there again.

Our conservative investment approach to managing our bond portfolio has again paid off. As we look forward to 2009 we are positioned to face the challenges with little risk. Our duration will be scaled back now that it appears there will be no further interest rate cuts by the Bank of Canada. Stability for the equity market will attract cash flows away from bonds. We will add to our corporate bond holdings after the beginning of the rally, when confidence surrounding the economy improves.