

The BonaVista Quarterly

Fourth Quarter 2010

Investment Strategy and Review

Looking back over the past few years in order to put some light on the big picture, 2008 saw the collapse of the global economy with financial freeze in market, 2009 was a year when markets were on steroids through sheer blunt force liquidity injections pumped into the system from every Central Banker and a very loose fiscal policy by every government. The economies and markets had no choice but to respond positively. In 2010, the world became somewhat more normal as economic recovery in the emerging world led to an economic recovery in the more developed world, although at a more anaemic pace.

Looking forward, 2011 will be the year the world goes from recovery to expansion, surpassing the previous economic indicators of global GDP. This is not to say that we won't see problems or set backs, those are a given, but there are enough positive forces in place to keep the system moving forward. As we did last year, we anticipate a bumpy road ahead but overall a positive outcome for the year.

To be sure, the world still faces many challenges, global trade imbalances, sovereign credit problems in Europe, US housing crisis, geo-political tensions, etc.

There is never a shortage of things to worry about, but on the positive side, it appears that economic growth is becoming self sustaining, where growth is strong enough to improve confidence, and confidence is strong enough to encourage hiring which will lead to income growth and spending which itself will lead to business investment and more growth. This environment should be positive for stock markets. This environment will also lead to higher interest rates and thus lower bond prices so we remain cautious on bonds.

Our expectation is that as the environment normalizes so too should returns. We began 2010 anticipating an 8 – 10% rate of return and ended up close to 12%. We once again feel that 8 – 10% should be achievable barring any unexpected negative developments.

Canadian Equities

The S&P/TSX put in a strong performance for the year up 17.6% well ahead of the S&P 500 and the MS EAFE index. This relative outperformance was even stronger when compared in Canadian dollar returns, as the S&P 500 was up 9.1% and MS EAFE 2.1%.

Our portfolio lagged the market during the year primarily as a result of our very limited exposure to gold stocks. We typically do not own gold stocks as we find these companies to be poor allocators of capital. They generated below average profits and typically sell at very expensive valuations. As value managers we have a difficult time embracing this sector.

The biggest impact on the market was the move in commodity prices which drove the Materials sector up 35.8% during the year. Within this sector Golds were up 26.2% and Diversified Metals were up 51.4%. Other notable moves during the year came from Consumer Discretionary up 21.8% and Telecom Services up 16.3%. At the other end of the spectrum Financials lagged the market up only 6.3% as a group with Banks up 6.1% outperforming Insurance Companies which were down 2.9%.

The positive contribution to fund performance came from above average weighting in Diversified Materials, particularly our exposure to Teck Resources. Other significant contributors were our

overweighting in three bank stocks which outperformed the market; Toronto Dominion, Bank of Nova Scotia and Canadian Imperial Bank of Commerce. We also benefited from strong moves in overweight positions in Canadian Natural Resources, Magna, Cenovus and Finning.

Looking forward we believe that many of the same issues will affect the markets in 2011 as those in 2010. The primary driver will be global economic growth, debt problems, both government and consumer debt, and as always, potential for political tension, and add to this unending regulatory reform.

Markets will once again have to climb a wall of worry. We like it like that, it keeps valuations in check. We anticipate market volatility to continue but feel confident the positive trends in place will outweigh the negative. With valuation still attractive, the markets should generate good returns.

US Equities

The US market finished the year on a very strong note, rising 10.8% (USD) in the fourth quarter, bringing the full year return to 15.1%. In Canadian dollar terms, the gains were more muted – rising 7.4% and 9.5% for the quarter and the year, respectively – as our dollar rose from approximately 94 cents to par against the U.S. dollar over the course of the year.

All ten market sectors posted positive returns for the second quarter in a row. The top performer was the Energy sector (+21.5%) which continued to bounce back from the Gulf of Mexico oil spill disaster earlier this year. The next best sectors were the economy-sensitive Materials (+19.0%), Consumer Discretionary (+12.6%) and Industrials (+11.8%). The weakest, but still positive, returns came from the defensive Utilities (+1.1%) and Health Care (+3.7%) sectors. These returns are the profile of an economy that is rebounding.

In response to some significant price moves over the past twenty months, we made a number of changes to our holdings over the course of the quarter.

We realigned our investments in the Financials sector over the past six months, placing a greater emphasis on banks, and less on insurance companies. Bank stocks will benefit from a recovering economy, favourable yield curve, improving profitability, the prospect of reinstated dividends and superior relative value. We added to JP Morgan and initiated a small position in Citigroup, while reducing Progressive and Cincinnati Financial, and eliminating Aflac. Counter to the strict theme, we added to Allstate, which looks particularly cheap, however our net insurance exposure is down. We also initiated a small position in AllianceBernstein, an investment management firm.

Within Health Care, we added to Gilead and WellPoint and initiated a position in Medtronic. These additions were partially funded by reductions in Merck and Pfizer. Our investment in “big pharma” companies has been reduced as the valuation premiums on biotechnology and medical device companies have fallen to nearly their lowest levels in over thirty years.

In Energy, we added substantially to ExxonMobil, the largest company in the S&P 500. ExxonMobil represents solid relative value and has underperformed the market by a wide margin over the past two years. We also eliminated our position in offshore driller Transocean, after its price gains in the aftermath of the Gulf oil spill, replacing it with Noble, a more attractively priced competitor. In just a few months, stocks tainted by a combination of the Gulf spill and depressed natural gas prices have rallied back dramatically, so we took some profits by reducing our holdings of Nabors Industries, Tidewater and Valero.

Within Consumer Discretionary, on account of valuation, we took profits in several holdings: Comcast, Home Depot and Johnson Controls, and eliminated CarMax. We added to our investment in McGraw-Hill and bought into the General Motors initial public offering.

In Information Technology, we made a material reduction in Dell, primarily due to lacklustre operating performance. We also trimmed our holdings of Microsoft, Qualcomm and ScanSource on relative price gains.

Lastly, we initiated a Utilities holding – Sempra Energy, a California-based electrical utility. This sector has become much more attractively valued over the past two years, and this purchase has given us our first representation in this sector in over a decade.

International Equities

The International portfolio had a great year in terms of performance, outpacing the MS EAFE index by a wide margin.

The primary driver of this outperformance was a combination of things. Firstly the portfolio has about a 12% exposure to the Emerging Markets (Brazil, China, Hungary, India, Korea, Malaysia and South Africa). These markets performed very well during the year up 12.7% (Canadian dollar return) compared with only 2.1% from MS EAFE index. This added significant value to the portfolio.

Further benefit came from being overweight strongly performing sectors of the market such as Industrials (up 17.3%), Consumer Discretionary (up 18.2%) and Technology (up 12.5%), while being underweight the weakest sectors of the market such as Utilities (down 9.8%), Financials (down 6.8%) and Healthcare (down 4.0%). These more macro factors account for much of the fund's outperformance. Stock selection within these weightings also contributed.

Several transactions were undertaken during the quarter to take advantage of price moves, locking in some profits in stronger performing stocks by reducing position while averaging down on some of the lesser performers where we still have conviction on the company.

One new name was added to the fund in December: Esprit (Hong Kong/Consumer Discretionary). Esprit is a leading apparel company with a globally recognized brand which is positioned in the “volume prestige” segment in Europe and Asia, with a small presence in the US. The Esprit brand is sold through a combination of their own retail stores and a variety of wholesale locations, including franchises. It was purchased at a P/B at 3.1x and a normalized P/E of 11.4x.

Bonds

The DEX Universe generated a negative 1% return during the fourth quarter bringing the full year return to 6.7%. Our portfolio outperformed the market during the year. The Federal Reserve lent support to US Treasury bond prices by initiating a second round of quantitative easing in order to provide more stimulus to the economy. This support was overwhelmed by the supply of new bond issues into the market, resulting in lower overall prices for the quarter.

The yield curve in Canada remains quite steep as both short and long rates drifted higher. The middle maturities (5 to 10 years) were the weakest part of the market as most of the new issues fell into this term.

Our portfolio was overweight this part of the market, as a result we underperformed for the quarter but outperformed for the year as a whole.

We initiated several trades within our corporate holdings. We sold our position in Cameco 10 year bonds to purchase more Manitoba Telecom of the same maturity. The Cameco bonds, which we had held since issuance in September 2009, had performed well in relative spread terms. The Manitoba Telecom issue lagged the recovery in corporate spreads and offered good value in a stable sector of the market.

We also added new positions in 5-year Bell Canada and Bank of Montreal. Both new issues were priced at generous spreads and due to their size are easily tradable.

There was little trade within our provincial holdings this quarter. Spreads were relatively stable and new issuance was well contained and soaked up by new cash. Our current Provincial exposure is close to neutral relative to the benchmark and provides our portfolio with a good core presence in that sector.

We continue to execute trades in and out of the Federal Agency issues both in the short and middle part of the yield curve. Our Canada Housing Trust holdings are some of the largest in our portfolio. They are AAA rated, fully guaranteed by the Canadian government yet offer higher returns.

Bond returns in 2010 were stronger than we had anticipated, but, looking forward, we believe the bond market has finally run its course. We are sitting on the brink of higher rates from the Bank of Canada. Our portfolio is currently profiled as neutral when compared to the DEX and we are eager to adopt a more defensive stature when the signals are a little clearer.