

The BonaVista Quarterly

Fourth Quarter 2006

Investment Strategy and Review

Over the fourth quarter the equity markets rebounded strongly from the lack lustre performance of the previous three months. As a result, we experienced another year where our investment strategy paid off and overall returns were exceptional. As we enter 2007, the US economy is experiencing a slowdown in GDP growth. This slowdown will also be reflected in the Canadian economy, as the US remains Canada's largest trading partner. However, we view this slowdown as healthy mid-cycle pause that will allow for an extended economic cycle with healthy growth beginning later in the year.

Equity markets have been supported by good earnings growth, clean balance sheets and strong cash flows. This led to record levels of share buy backs and merger and acquisition activity all over the globe. We believe this liquidity will continue to support global growth as well as market fundamentals.

With interest rates at fairly low levels our view is that returns from the bond markets will be limited and, therefore, the equity markets provide the potential for more upside. As a result, we will maintain a favourable disposition toward equities within our asset mix and an underweighting in the fixed income markets.

Canadian Equities

The S&P/TSX put in a fourth straight year of good performance with a total return of 17.3% over the year. While this was not the best performing market globally it was still a very respectable return and outpaced once again the S&P500, making this an unprecedented fifth year in a row where Canada has beaten the US.

The performance of the market was led by the materials sector which was spurred on by record high commodity prices across many of the metals, fertilizers and chemicals. Of the other few major sectors of the market, energy stocks significantly underperformed as the price of oil retreated from the highs set earlier in the year and the financial services sector performed slightly ahead of the overall S&P/TSX return.

Our Canadian equity portfolio outperformed the market over the year as a result of good stock selection which saw the portfolio participate in several of the largest takeovers within the Canadian market. During the year the following stocks held in the portfolio were tendered into takeover bids: Vincer, Dofasco, Inco, Falconbridge, Maverick Tube and ATI Technologies.

Going forward we continue to believe the Canadian market is well positioned to benefit from strong global growth. We also believe the market valuation is reasonable given current earnings coupled with a low interest rate environment. Our portfolio currently reflects a fairly neutral weighting on a sector basis relative to the market, as we prefer to take stock specific exposure at this stage.

During the final quarter of the year we initiated a small position in two new names. One of those stocks is the TSX Group Inc., which runs Canada's senior equity exchange as well as Canada's Venture Exchange. At its current price the TSX Group appears reasonably valued given its earnings growth and its strategic position within the Canadian listing and trading environment. The second added stock was MacDonald Dettwiler, which is primarily a provider of strategic land information, collecting, producing and selling data for land registry and mortgage documentation in Canada and the UK. At about 19x this year's earnings, the stock is trading at a slight premium to the overall market but generated a higher return on equity and has better earnings growth prospects as well. We therefore feel comfortable that we are getting value for our money despite the small premium being paid.

US Equities

The US portfolio underperformed the S&P 500 over the quarter and full year due largely to the weak performance of stocks in the Energy sector. The portfolio's absolute return was aided by the weakness in the Canadian dollar which added over 4% to the final quarter's results.

We take a "one stock at a time" approach to ensure that our individual holdings and the portfolio as a whole is representing the best value possible. As a result, our portfolio is often made up of names that have weightings that are different than the respective weight within the index. This may create short-term volatility (in comparison to the index) and certainly did in 2006, but over longer time horizons, the portfolio has achieved superior investment performance.

We began to address the weakness within the Energy sector by reducing our holdings of Chesapeake Energy, redeploying the funds into ConocoPhillips and Nabors Industries. Chesapeake Energy trades at normalized price/earnings multiples of 12X while the normalized price/earnings ratio for ConocoPhillips is 9X. Nabors trades at less than 7X its 2007 earnings. These moves have positioned the portfolio in companies with more compelling valuation.

We initiated a position in Progressive, America's third largest auto insurer. The company is run with a remarkable focus on profitability, consistently earning returns far superior to that of its competitors. Additionally, management has an exemplary focus on customer service - for example, providing onsite claims payment at the scene of an accident - which has helped the company grow at almost triple the pace of the industry over the past four decades. Worries about intensifying competition have caused the shares to drop almost 20% this year, providing an opportunity to invest in this excellent company at an attractive price. With less than an 8% share of the total auto insurance market, we think Progressive has many years of growth ahead of it, and will likely continue to build this position over time. The stock carries a normalized price/earnings of 14X.

Dean Foods was eliminated on account of price appreciation; the stock was no longer attractive on our metrics and was sold early in the quarter. Both NS Group and North Fork Bancorp were eliminated through takeovers.

Similarly, we sold down some of our holdings in Allstate, Comcast, Liz Claiborne and Phelps Dodge on price appreciation. Phelps Dodge was the subject of a takeover bid from Freeport McMoran and our sale was made after the deal was announced. In the case of Comcast, we will likely continue to reduce or eliminate the position on further appreciation.

Over the past three months, the stock market has run exactly counter to the headlines and news reports. Media expectations of weakness have been offset by stock market strength. Time will tell whether or not this remains the case, but it does illustrate an important point. It is paramount that we focus upon the individual values in the market.

International Equities

The international equity portfolio return in the fourth quarter was 17.2% versus a 15.3% return from MSCI EAFE. For the one-year period, the portfolio's return of 30.5% compared with an MSCI EAFE return of 26.8%. The portfolio's underweighting in Japan contributed positively to relative performance along with exposure to the emerging markets, while a combination of stock selection and market allocation also helped in Holland and Singapore. In sector terms, the portfolio outperformed in Materials, Financials, Health Care and Energy and underperformed in Consumer Discretionary. All country and sector exposures are of course a residual of the stock selection process.

Over the quarter, Europe outperformed versus the Pacific region. In the developed markets, Norway and Singapore were the best performing countries. Emerging markets outperformed EAFE over the quarter.

All ten sectors in the MSCI EAFE Index had positive returns for the quarter. The sector with the largest return was Telecommunication Services. The sector with the weakest return was Health Care.

The portfolio continues to have a lower weighting than the EAFE benchmark in the Pacific region and in Europe. Within the Pacific region, the portfolio remains underweight in Japan, explained by a continuing absence of good values. Within Europe, the portfolio is overweight in the U.K., the largest country exposure in the portfolio. Exposure to emerging markets (non-EAFE markets) increased over the quarter to 12.8% at the quarter end, as we have continued to find good values there.

In sector terms, the portfolio is most significantly different to the benchmark by being overweight in Materials, Consumer Discretionary and Industrials and underweight in Consumer Staples and Financials.

During the fourth quarter, the portfolio purchased four new holding including the first exposure to India: Oil & Natural Gas (India/Energy), Grafton Group (Ireland/Industrials), Hero Honda (India/Consumer Discretionary) and GAIL (India/Utilities). One holding was eliminated: HAECO (Hong Kong/Industrials).

Bonds

The Scotia Capital Universe Index (SCUI) was up 70 basis points during the quarter, bringing the annual return to 4.06%. Our bond portfolio outperformed the SCUI and closed the year up 4.13%. During the quarter, the markets reacted to the increasing prospect that the tightening cycle pursued by the North American central banks was complete. Government of Canada bond yields across the 2-30 year curve moved lower by about 15 basis points in the quarter bringing them roughly back to where they had started the year. This was quite surprising given that the tightening actions by the Bank of Canada had seen the bank rate increased by 75 basis points during the year. The yield curve by year-end was almost flat, offering little more than 10 basis points in yield from 2 year to 30 year Government of Canada bond maturities.

Trading in the portfolio continued to be light over the quarter as we approached the market with caution. The duration of the portfolio, which had been drifting longer in Q3, maintained that posture until the year-end when it was taken back to neutral. Trades initiated in the government bond sector captured small shifts in the yield curve as price volatility increased.

Corporate spreads in Canada barely tightened relative to benchmark Government of Canada bonds, across the entire credit curve, as the market shook off an increase in new issuance. A shortfall of new issues in the early fall meant investors still had money to invest. Cash provided from the December 1 coupon payment and the subsequent duration extension of the SCUI contributed to the market's ability to absorb new product. We took advantage of spread volatility by repositioning several issues. Our corporate portfolio continues to be heavily weighted in the security of the financial sector. We also sold our position in EPCOR 2010 bonds to purchase Bell Aliant 2016's. We had owned the EPCOR for many months and the spread relative to bonds had narrowed 25%. The Bell Aliant spreads widened quickly following the news on income trusts and the re-action of BCE. This provided us with a good buying opportunity, which has already worked in our favour. The portfolio weighting in the corporate sector at year-end is 30%. This is neutral when compared to the SCUI.

In our provincial bond holdings we initiated several trades to capitalize of the shifting of the yield curve and the tendency of certain benchmark bonds to become expensive. We sold our FINQ issue that we purchased in Q3 in favour of a shorter dated government agency. A temporary inversion of the curve was the catalyst for the trade. We added a position in Alberta treasury 5-year notes to deploy the cash received on December 1. Provincial spreads remain fairly contained while finances overall stay in solid shape. The East/West divergence may narrow into the New Year as oil prices retreat from their record summer levels and manufacturing in the East benefits from a weaker Canadian currency. With only three provinces forecasting budget deficits in fiscal 2006/07, new issuance should be minimal and therefore

supportive of spreads at current levels. Our portfolio is still underweight this sector versus the benchmark. If spreads remain the same this is unlikely to change.

Our forecast for the Canadian bond market in 2006 was for coupon level returns. That is exactly what we got. Moving into 2007, there seems little reason to believe that it will be a more robust year for bond investors. The yield curves in North America are flat. Long-term bonds offer a poor trade-off between risk and return at these low yield levels. The central banks will continue to scrutinize the economic data closely watching for any sign of creeping inflation. Our portfolio will be managed with caution in order that we can continue to provide you with consistent returns.