

The first quarter of 2008 proved to be a very difficult one with all sectors of the equity market except for energy, materials and mining losing ground. There were virtually no equity sectors in which to hide without taking a significant overweight position in resources, a particularly risky prospect considering the high volatility of commodities.

As a reminder, because of the different risk profiles of our clients, securities mentioned will not necessarily be included in all the portfolios.

## The Clean-Up Continues

The clean-up of problems plaguing the US “alphabet soup” of securities such as ABCP, CDOs, MBSs and SIVs continued during the quarter. Debt issuers and banks operate by taking short-term deposits that pay a paltry amount of interest, and then, lend money to fund longer-term loans and mortgages at higher interest rates. The lenders maintain reserves, typically less than 10% of the amount loaned. This works well until all the depositors demand their money back at the same time, leading to a run on the bank. When the depositors can’t be repaid the credit market freezes. This is essentially what is happening today in the debt markets. In the case of Bear Stearns, a US investment banker, clients demanding their money back caused a liquidity crunch, forcing the US Federal Reserve to intervene to prevent Bear Stearns’ bankruptcy.

In contrast to the US market, the TSX performed reasonably well in the quarter but with over 40% of the index in resources it is very skewed towards commodities relative to the global economy. One may ponder the question, is the overweight in commodities in the TSX similar to the technology (Northern Telecom) overweight experienced in 2000? The table below summarizes recent market performance, all presented in Canadian dollar currency terms.

Market Indices (\$C)	Year 2006	Year 2007	Q1 2008
TSX (Canadian market)	15 %	7 %	-3.5%
S&P 500 (US market)	14 %	-11%	-6.3%
Nasdaq (mainly tech.)	10 %	-6 %	-11 %
MSCI World	21 %	-6 %	-5.3%
MSCI EAFE (Int’l)	27 %	-5 %	-5.2%
S&P/TSX Medium Bond	4 %	3 %	3.7 %
US\$ relative to Cdn\$	1 %	-15%	+ 4 %

The performance of the MSCI EAFE and MSCI World indices were boosted by the Euro’s 11% appreciation relative to the Canadian dollar during the quarter.

## Portfolio Activity

For accounts that transferred in as cash, purchases during the quarter included Artis REIT (AX.UN: TSX) a western Canada based Real Estate Investment Trust; Atco (ACO.X: TSX) a power producer, utility and related service provider; Economic Value Trust (EVT: TSX) a global closed-end fund and Canadian bank/corporate bonds.

Artis REIT holds industrial, office and retail real estate in western Canada and is currently able to increase rents on lease renewals by more than 30%. Its distribution yield is 7% with a payout ratio of 75%. Atco Group is an Alberta based worldwide organization of companies comprised of three main business divisions: Power Generation; Utilities (natural gas and electricity transmission and distribution) and Global Enterprises, including companies active in industrial manufacturing, technology, logistics and energy services. Both Artis and Atco are enjoying the benefits of the strong western Canadian economy.

EVT has historically outperformed the MSCI World index, has a low MER (management expense ratio) of 0.35% and invests in companies globally, 47% in Canada, 19% in US, 19% in Europe and 15% in Asia. EL Financial (ELF: TSX) represents a 25% holding within EVT.

Because of the fear surrounding bank and corporate debt, the yields on bank and corporate bonds are relatively attractive compared to government bonds. We added corporate and bank bonds to RESPs with maturities in August or September to accommodate withdrawals for tuition payments.

Securities sold were Chartwell REIT, China 3C Group, Rogers Communications, Medicare and the small holding of Bell Aliant that resulted from the spin-off from BCE.

Although at first blush Chartwell REIT, a long term care provider, would appear to be well positioned, the execution by management has been dismal. It could have been sold in a private equity transaction for \$13 to \$17 per share over the past year but now after a distribution cut is trading between \$9 and \$10. Recently it refocused its strategy on organic growth versus growth through

acquisition which will make it more difficult to increase revenues. Chartwell has the challenges of increasing prices in a government controlled healthcare environment and will have to restructure itself before 2011 or face becoming a taxable entity.

China 3C Group provided an unpleasant surprise in their most recent earnings release. For 2008 they are forecasting a reduction in revenue and decline in gross margin of 4% to 5%. This is obviously unacceptable for a company that grew its revenue by more than 400% in 2006 and by 85% in 2007.

The pending battle in the Canadian wireless sector is expected to be intense. We anticipate that Rogers' wireless profits will be lower than analysts' forecasts. The industry has a reasonably good understanding of new entrant risks but we believe it underestimates the counterpunch from Telus and a soon to be privatized BCE.

Isotechnika and Medicure are more speculative Canadian biotech companies that are presently in Phase 3 drug trials. Isotechnika has a promising drug, Voclosporin, to treat autoimmune diseases such as psoriasis and for use in the prevention of organ rejection in transplantation. We have high expectations that Voclosporin will ultimately be commercialized through Isotechnika's relationships with Atrium Medical, Cellgate, Lux Biosciences and/or Roche. Unfortunately, Medicure's MC1, used to reduce the incidence of cardiovascular death up to 30 days following coronary artery bypass surgery failed to meet its endpoint in Phase 3 clinical trials. Given this disappointing result, Medicure was sold. Companies of this ilk will rarely be included in portfolios, and if so, only in small amounts for more aggressive clients.

Manulife, Shopper's Drug Mart, Thomson, CVS Caremark and EL Financial were added to accounts that didn't already hold them. CVS Caremark is a US based retail drug store chain and pharmacy benefit management service provider. The pharmacy benefit management services offered are mail order pharmacy; specialty pharmacy; plan design and administration; formulary management; and claims processing services primarily to employers, insurance companies, unions, government employee groups and managed care organizations. EL Financial is an undervalued (P/E: 9, P/B: 0.8) Canadian corporation that holds Empire Life and Dominion of Canada General Insurance, a property and casualty company.

## Outlook

Our best guess is that we are entering the 2<sup>nd</sup> quarter of a US recession. Historically, this would imply that jobless claims should soon climb from the 350,000 level by an additional 25%, unemployment will increase from the ~5% level to ~7%, company earnings will continue to decline into 2009 and the ISM Purchasing Managers Index (PMI) is likely about half-way through its decline. The PMI is a survey of corporate purchasing managers' buying intentions and at its present value of 48 is indicating that industrial activity is contracting. A reading of 50 is considered the expansion/contraction threshold. If this is a typical downturn, housing starts, production and new orders might begin to improve later this summer while employment and earnings may not improve until mid 2009.

The good news, and yes there is some good news, is that typically the market peaks about 6 months prior to the start of an economic contraction and bottoms approximately 6 to 7 months into a recession. This would imply that we are about two-thirds of the way through the market decline and bottoming process. Clearly, the stock market is a forward-looking, leading indicator. Based on 9 recessions since 1953, the average recession has lasted 11 months but this timeframe has varied significantly. For example, the market bottomed 18 months after the start of the 2001 recession and 10 months after the 1973 recession began.

The portfolios have significant cash balances, 15% plus, which will be invested as we reach that mythical market bottom and start to see some recovery.

## TFSA Accounts

The new TFSA (tax-free savings account), recently tabled in the Federal budget, will allow Canadians 18 years and older to save up to \$5,000 per year and avoid tax on any investment income earned. Unused contribution room can be carried forward to future years and cash can be withdrawn tax-free at any time. The TFSA is a great way for investors to grow non-registered assets. We will keep you posted on further developments as the accounts become available in early 2009.

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