Portfolio Review – Q2 2009

The market rally that began in March was a pleasant surprise that continued throughout the second quarter. Bad news was absorbed with minimal price damage and good news resulted in more market upside. The credit market improved with the yield spread between corporate and government bonds shrinking, resulting in higher corporate bond prices. The table below summarizes the market performance as of June 30th, 2009 in Canadian dollar terms.

Market Indices ($Cdn)	Year 2008	YTD 2009	Q2 2009
TSX (Canadian market)	-35 %	15 %	19 %
TSX Canadian Small Cap	-45 %	16 %	21 %
S&P 500 (US market)	-24 %	-3 %	6 %
Nasdaq (mainly tech.)	-27 %	11 %	11 %
MSCI World	-27 %	2 %	12 %
MSCI EAFE (Int'l)	-30 %	4 %	16 %
iShares Cdn Short Bond	8 %	0 %	0 %
US$ relative to Cdn$	22 %	- 5 %	- 9 %

Relative to a global balanced portfolio of passive indices, conservative-growth and growth oriented client portfolios have outperformed by approximately 6% year-to-date. Some of the securities mentioned will not necessarily be included in all portfolios due to the different risk profiles of our clients.

Portfolio Activity

As a result of the improving credit environment, there was more activity related to corporate bonds than with equities during the second quarter. We sold all of the BMO, BNS, CIBC and RBC Canadian bank bonds for a profit and replaced them with high-quality corporate bonds that offer superior yields-to-maturity. For example, we replaced a Bank of Nova Scotia 8-Apr-13 bond yielding 2.9% to maturity with an American Express Canada 2-Apr-13 bond yielding 5.7% to maturity. The Bank of Nova Scotia bond was originally purchased near par ($100) and was sold at $108.

When share prices of **Atco** (ACO.X – TSX), **Artis REIT** (AX.UN – TSX), **BCE** (BCE – TSX), **E-L Financial** (ELF – TSX), **Enbridge** (ENB – TSX) and **Shopper's Drug Mart** (SC – TSX) came under pressure, they were selectively added to portfolios.

In accounts holding the medical laboratory testing company, **Quest Diagnostics** (DGX – NYSE), these shares were sold and replaced by **Medtronic** (MDT – NYSE). Quest Diagnostics had held up well through the market turmoil but became overvalued relative to Medtronic. Medtronic has six major businesses that focus their efforts around a condition or therapy type: Cardiac Rhythm Disease Management, Spinal and Biologics, CardioVascular, Neuromodulation, Diabetes, and Surgical Technologies. MDT is the world's largest manufacturer of implantable biomedical devices, with sales to over 120 countries. Cardiac Rhythm Management products (bradycardia & tachycardia) accounted for 37% of 2007 sales; Neurological, Spinal, and Diabetes, 39.3%; Vascular products (stents), 15.8%; and Cardiac Surgery (heart valves, perfusion systems), 8.2%.

Business outside of the US represented 38% of 2007 sales and 55% of profits. Historically, MDT has traded at an average P/E of more than 20 but is now trading at an attractive forward P/E of 10. In addition, it pays a 2.3% annual dividend.

Outlook

There has been much talk in the press about "green shoots", signs that the economy is starting to recover. We have updated some of the economic indicators outlined in the Q4 2008 Portfolio Review below.

- Stabilization of US home prices. The prices of US homes have continued to fall but at a lower rate. Most recent April 2009 data shows US home prices falling by ½ % per month versus 2% in earlier months. Canada's housing market is showing much better resilience with home sales increasing lately.
- A break in the credit crisis. The credit markets have improved with many companies being able to issue corporate bonds at progressively lower interest rates.
- An uptick in consumer confidence survey numbers. The University of Michigan Consumer Confidence index has increased steadily since November reaching 70.8 in June, 2009.
- A decline in write-downs and bailouts in the banking industry. Several US banks have started repaying their TARP money back to the US government.
- A stop in the decline of, or increases in, retail chain same-store sales. The consumer is still struggling with a heavy debt load which has resulted in declining same-store sales for retailers other than discount stores.
- A reduction in the weekly reported jobless claims for non-farm payrolls. Jobless claims have recently fallen below 600,000 per week down from 650,000 per week a month ago.
- An increase in both the manufacturing and non-manufacturing ISM (Institute of Suppliers and

Manufacturers) indicators. Although the ISM readings remain below 50, indicating the economy is still contracting, they have improved from readings in the mid 30s six months ago to about 45 in June.

The above signs provide a mixed message, some improving and others still falling, although, at a slower rate. After an outstanding quarter we expect a market pullback sometime over the course of the summer. During this earnings season, investors will have to differentiate whether positive company earnings are due to an improvement in the future business outlook or simply the result of cost cutting.

One area that could be a cause for concern is in commercial real estate. After very loose lending standards for the past few years, banks are implementing tighter controls and non-bank lenders are withdrawing from the market. This will make it difficult for commercial real estate owners to renew their mortgages, particularly, if several of their tenants have declared bankruptcy.

In a market pull-back we would use some of the cash on hand to add to sectors that move first in a economic recovery; consumer discretionary, financial, technology, energy and emerging markets.

$US Registered Plans

This autumn we will have the ability to offer US dollar-based registered accounts such as RRSPs, LIRAs and TFSAs. These will be attractive for registered accounts holding US assets because it will avoid Canadian to US dollar exchange costs when buying and selling US securities within the plans. We will follow-up with you if any additional information is required in order to open these accounts.

Proposed CPP Changes

The Federal and Provincial governments have proposed changes to the Canada Pension Plan. The good news is that despite recent investment losses -- $23.8 billion in the last fiscal year -- the CPP is still in good shape based on the current mandatory contribution rate of 9.9 per cent of pensionable earnings, which is split equally between employers and employees. The current maximum pension available at 65 is about $910 a month. The changes described below are designed to encourage people to work past age 65.

- The program adjustments will start in 2011.
- Under the new rules, you will no longer have to quit working for two months in order to start collecting benefits.
- the penalty for early retirement is being increased, from 0.5 per cent per month to 0.6 per cent. That represents a 36-per-cent reduction in the maximum monthly payment if you start collecting at age 60.
- when working past 65 the maximum pension will be increased by 0.7 per cent for each month you continue to work and make contributions. People who continue to work after 65 will be able to continue to make contributions until age 70, but contributions will be voluntary.
- one change that should benefit many pensioners regardless of when they retire is an increase in the number of low-income years that can be dropped from the calculation of lifetime pensionable earnings.

Government Grants for ecoEnergy Home Retrofits

In addition to the HRTC (Home Renovation Tax Credit) that provides a 2009 non-refundable tax credit up to $1,350, the Federal and Ontario governments are providing grants for energy retrofits to your home.

The ecoEnergy Retrofit – Homes program, sponsored by Natural Resources Canada, is offering residential energy efficiency evaluations through licensed service organizations. Property owners can qualify for Federal and Ontario government grants by improving the energy efficiency of their home.

Below are some examples of the grants available.

Improvement	**Federal Grant**	**Ontario Grant**
EnergyStar qualified furnace	$790	$790
Water Heater upgrade	$375	$375
Air sealing (i.e. caulking)	$190	$190
each Window or Door	$40	$40
Low flush toilet	$65	$65

Additional information about this program can be found at www.nrcan.gc.ca.

If you have any questions or comments regarding items discussed in this newsletter please contact us.

Doug Garner, P.Eng., CFA
President, Portfolio Manager
Jane Garner, BA, EPC
Vice-President