

During the quarter the commodities balloon burst, oil fell from US\$140 to US\$100 per barrel and the CRB Index (all commodities index) declined by 26%. This caused the TSX, with its 50% plus weighting in energy, mining and fertilizer companies, to fall by 19%. Unfortunately, other sectors of the market didn't fare much better resulting in negative portfolio performance for the quarter. Because of the different risk profiles of our clients, securities mentioned will not necessarily be included in all the portfolios.

Credit Crisis

After a hiatus in the second quarter, the credit crisis re-ignited with the failure of Bear Stearns, the takeovers of Merrill Lynch by Bank of America and Lehman Brothers by JP Morgan, and the US government bailout of Fannie Mae, Freddie Mac and AIG. The decline of the US real estate market has resulted in many houses holding mortgages that are greater than the value of the home. These mortgages, sliced and diced into MBSs and CDOs, are now in default putting bank balance sheets offside. The banks then try to supplement their capital base but the fear of bankruptcy results in a lack of interested parties coming to their rescue. This has made banks unwilling to make loans for fear they will not be repaid and has resulted in a loss of investor confidence. The lack of confidence creates the vicious cycle of: few bids for stocks → a decline in stock prices → margin calls and mutual/hedge fund redemptions → more selling and fewer buyers → taking us full circle to a lack of stock bids. We won't elaborate too much further as this is the lead story on the TV news and the front page headline in newspapers.

Needless to say these events have had a profound negative effect on the world's stock markets. The table below summarizes market performance as of September 30, 2008 presented in Canadian dollars.

Market Indices (\$C)	Year 2007	2008 YTD	Q3 2008
TSX (Canadian market)	7 %	-15 %	-19 %
S&P 500 (US market)	-11 %	-15 %	-5 %
Nasdaq (mainly tech.)	-6 %	-20 %	-10 %
MSCI World	-6 %	-18 %	-12 %
MSCI EAFE (Int'l)	-5 %	-24 %	-17 %
DEX Mid-term Bond Index	3 %	4 %	1 %
US\$ relative to Cdn\$	-15 %	7 %	4 %

Portfolio Activity

Activity within the portfolios for the quarter was low as it seemed unwise to utilize portfolio cash to purchase declining securities. **Agrium (AGU: TSX)** was sold for a profit as the fertilizer segment of the commodities world became overheated. For accounts without any bank holdings, **TD Bank (TD: TSX)** was purchased during the financial stock sell-off in July. TD is well positioned to grow its franchise by expanding and improving its retail oriented US bank network. With its strong retail presence, TD is less reliant on investment banking which is in disarray in these poor market conditions. Its retail focus is the result of its acquisition of Canada Trust and Ed Clark, Canada Trust's CEO prior to becoming TD's CEO.

Another buy was **iShares FTSE/Xinhua China 25 Index (FXI)** that consists of 25 large capitalization stocks based in China. All the stocks are available to international investors and trade on the Hong Kong exchange. The top four holdings as of September 30th, 2008 are China Mobile (10%), Industrial & Commercial Bank of China (10%), China Life (10%) and PetroChina (8%). China Mobile is the largest wireless carrier in the world, adding over 8 million subscribers per month. As a comparison, Canada has approximately 20 million subscribers so China Mobile could provision all of Canada's wireless customers in less than 3 months. These four non-export oriented companies are focused on serving the local Chinese population which should provide some insulation from the slowdown in the mature economies of North America, Europe and Japan. China's GDP is expected to slow to about 8% from its typical growth rate of more than 10% per year. After some monetary tightening China's inflation rate has started to decline, allowing the central government to re-focus its efforts on growing the economy. Since July, China has loosened loan quotas, encouraged lending to small businesses and increased export-tax incentives for makers of garments and textiles to boost growth and protect jobs. The central bank last month cut borrowing costs for the first time in six years and has trimmed the pace of Yuan (Chinese currency) gains. Unlike the G7 countries (Canada, France, Germany, Italy, Japan, UK and US) who all have large debt loads, China has the largest US dollar foreign exchange reserves in the world, \$1.2 trillion US dollars.

These large reserves provide China the opportunity to create economic growth and consumer demand through public projects such as infrastructure development. Recently, FXI has come under selling pressure because it is very liquid, trading about 27 million shares per day in New York and is considered a risky emerging market. Once investor sentiment improves we expect FXI to outperform.

To generate income in non-registered accounts we utilize preferred shares that are either retractable or soft-retractable. Retractable preferred shares can be redeemed by the holder on specified dates at par value, usually \$25 per share. Soft-retractable preferred shares can be converted to another series of preferred shares on a specified date, typically 5 years from issue, at a nominal value of \$25 per share. This quarter the **Royal Bank preferred series N** were redeemed by the bank for proceeds of \$25 per share. To replace these preferreds we purchased **Bank of Nova Scotia series R preferreds** that pay a 5% dividend and are soft-retractable in 5 years. The retractable feature is important because irrespective of future interest rates or inflation the shares will be valued at approximately \$25 upon retraction.

For RESP accounts that will be in existence for another 4 – 5 years we purchased the **RBC Canadian Dividend, F-Class** mutual fund. Series-F mutual funds can only be held in Financial Advisor managed accounts, pay no trailer fees and therefore have lower MERs (management expense ratios), 0.89% in this case.

Outlook

Headline news often mentions or draws a comparison between the Great Depression and our present economic circumstances. We doubt that our present situation will be that dire because:

- The governments and central banks have intervened decisively to boost confidence and arrange takeovers of failing financial institutions. In 1929 people lost all faith in the economic system which led to events such as runs on the banks (people withdrawing all their money from banks).
- There was no deposit insurance such as CDIC for our banks and CIPF for investment dealers.
- At that time the central bank raised interest rates rather than add liquidity to the economy by reducing interest rates and backstopping money market funds.
- Unemployment insurance did not exist so people had no buffer if they became unemployed.

- Today, global trade is an accepted economic practice versus trade barriers established during the 1930s.
- Ben Bernanke, the US Federal Reserve Chairman has studied the Great Depression extensively and has taken the opposite course of action to what was taken then.

We are likely in a recession, perhaps a somewhat deeper than normal one. During times like these, dividend paying stocks hold their value better than small cap growth stocks. At this point, over three-quarters of the stocks held in portfolios pay dividends. Generating dividend income can help supplement returns in a sluggish economy.

The portfolios still have cash balances of 10 – 15%, which will be invested in dividend paying stocks when a sustainable market recovery begins.

TFSA Preparation is Underway

Legislation governing Tax Free Savings Accounts (TFSAs), announced by the government in its February 2008 budget, received Royal Assent in June. Commencing in early January 2009, Canadian residents aged 18 and older may contribute up to \$5,000 per year to a TFSA. They will not be taxed on any investment income and will not have to pay taxes on the money that is withdrawn from the account. However, the contributions made to the TFSA are not tax-deductible. If an investor is unable to contribute the full \$5,000 in a given year, he or she may carry forward the portion that is unused and make a contribution in future years as there is no lifetime limit. We will notify clients when internal systems are in place and applications are available, in the upcoming months.

Attention College/University Students

OSAP has recently introduced a new grant to assist full-time college and university students with textbook purchases. The grant is presently \$150, but will increase to \$300 per year when fully implemented. Students may apply online. Go to the OSAP website, click on Grants & Bursaries, then Textbook and Technology grant.

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