

Contrary to the popular adage “sell in May and go away”, the market continued to climb throughout the third quarter. The table below summarizes market performance as of September 30th, 2009 in Canadian dollar terms.

Market Indices (\$Cdn)	Year 2008	YTD 2009	Q3 2009
TSX (Canadian market)	-35 %	27 %	10 %
TSX Canadian Small Cap	-45 %	43 %	22 %
S&P 500 (US market)	-24 %	3 %	6 %
Nasdaq (mainly tech.)	-27 %	18 %	7 %
MSCI World	-27 %	10 %	8 %
MSCI EAFE (Int'l)	-30 %	13 %	10 %
iShares Cdn Short Bond	8 %	4 %	1.6 %
US\$ relative to Cdn\$	22 %	-14 %	-8 %

In addition to the strong equity market, the improving credit environment resulted in increased corporate bond prices, a nice bonus to collecting the interest coupons. Some of the securities mentioned will not necessarily be included in all portfolios due to the different risk profiles of our clients.

Portfolio Activity

During the third quarter, we sold several low-yielding corporate bonds that were maturing in 2010 and added higher-yielding bonds maturing in the 3 to 7 year range. Specifically, we purchased infrastructure-based bonds, AltaGas Income Fund and Brookfield Asset Management maturing in 2014, yielding 5.7% and 6.7% respectively. In addition, bonds issued by two REITs, a Boardwalk 2012 bond yielding 5% and Calloway maturing in 2016, yielding 7.3%, were purchased.

The Ontario government has proposed reducing the amount of money paid to pharmacies per drug prescription filled. When the announcement was made the stock prices of the publicly traded pharmacies came under pressure. This proposal is still in negotiation between the government and the major pharmacy chains but will likely have some negative earnings impact for the pharmacies. In the case of **Shopper’s Drug Mart** (SC – TSX) we feel that the decline in the share price more than compensates for the financial effect of the new legislation so we added SC to some accounts.

Our holdings of **China Construction Bank** and **Bank of China** were sold during the quarter because of our concern about the credit quality of loans being made to stimulate the Chinese economy and, perhaps, prop-up the Chinese stock market. In any event, there

is a lack of transparency and a conflict of interest with the Chinese government controlling the stimulus package purse-strings and also being a majority shareholder of the Chinese banks. To retain our participation in the growth of the Chinese market we added **iShares FTSE/XIN China 25** (FXI – NY) to portfolios. FXI is diversified across multiple sectors of the economy and holds 25 of the largest Chinese companies. Many of the companies such as China Mobile, PetroChina, Huaneng Power, China Life, and the banks serve local consumers versus being heavily dependent on exports.

On July 20th **TransAlta** (TA – TSX) made an offer to acquire **Canadian Hydro Developers** (KHD – TSX) for \$4.55 per share. When the share price approached \$5 we sold our holdings. KHD had been trading at about \$3.50 prior to TA’s bid and last week agreed to be acquired at \$5.25 per share.

Since the acquisition of Reuters by Thomson, now renamed **Thomson Reuters** (TRI – TSX), there was an arbitrage opportunity between the London-based shares derived from the original Reuters stock and the Thomson shares trading in New York and Toronto. For US-dollar based accounts, we had purchased the lower priced London-based shares trading in New York as an ADR (American Depositary Receipt). Recently, Thomson Reuters delisted the London-based shares and exchanged them for TRI shares providing us with a 15% gain.

Suncor Energy (SU – TSX) an integrated energy company, is primarily known for its Oil Sands operation which recovers bitumen, primarily through oil sands mining and in-situ development, and upgrades it into refinery feedstock, diesel fuel, and by-products. As a result of Suncor’s acquisition of **PetroCanada**, portfolios holding PetroCanada have had each share converted to 1.28 Suncor shares. In order to get the takeover approved, Suncor must divest of 104 service stations in Ontario so Sunoco stations will eventually change ownership.

EL Financial (ELF – TSX), our largest financial holding, is a holding company that contains Empire Life and Dominion of Canada General Insurance, a property and casualty (P&C) company. It trades at a discount with a Price/Book (P/B) value of 0.75, low relative to its peers. EL Financial’s investment portfolio and both the life and P&C insurance businesses have suffered through the recession but with stronger equity and bond markets and signs of an economic recovery its share price has finally started to climb.

Outlook

We are now near an inflection point as the TSX has climbed 50% from its low on March 9, 2009. The front page of the October 5th Business Week magazine says it all, “Why the Market will keep going up, the storm has passed and the old rules of risk and reward are back”. Then turning the page upside down it says, “Why the market is going nowhere, the old rules no longer apply and a dreary decade lies ahead.”

Investors have certainly raised their risk appetite recently, evidence being:

- New issues of shares are being offered every day, particularly in lower quality securities such as junior mining stocks and even Air Canada !
- M&A (merger and acquisition) activity has increased (i.e. Suncor acquiring PetroCanada)
- New money is being deployed into the market on the smallest of pullbacks, particularly into the higher risk sectors such as materials and technology.
- Canadian home sales are increasing in quantity and price.

Our present thinking is that the market is due for a correction or at least a rest as the market seems somewhat frothy at this point. Once the economic fundamentals become more in line with the market valuations then we could see the resumption of higher market prices.

Given this uncertainty, our approach remains to invest in high quality, dividend paying companies spread across the major market sectors; real estate, utilities, financial, consumer, healthcare, industrial, energy, materials and technology. For the fixed income portion of the portfolio we are invested in short-term, high-quality corporate bonds.

\$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 a high percentage of 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.

Registration Reform (NI 31-103)

This topic, National Instrument 31-103, may not be of interest to every reader but it is important because it defines the necessary qualifications for firms and individuals that operate in the investment business.

For the past several years, the Canadian Securities Administrators in conjunction with the provincial securities regulators have been developing a new set of standards for registering investment firms and their representatives. The new legislation referred to as, National Instrument 31-103, became effective on September 28th, 2009. Under National Instrument 31-103, the test for determining whether a firm or individual is required to be registered will depend on the concept of the “business trigger”, that is, whether the firm or individual is “in the business of”:

- Trading in securities as a principal or agent; where upon registration as a “dealer” will be necessary. Representatives in this category will be referred to as a “Dealing Representative”.

OR

- Advising others about acquiring or disposing of securities; where upon registration as an “adviser” will be necessary. Representatives in this category will be referred to as an “Advising Representative” or “Portfolio Manager”.

As an example, in the firm category, YouFirst Financial was previously registered as an “Investment Counsel/Portfolio Manager”. This has now been simplified to “Portfolio Manager”. Within the representative category, Doug is an “Advising Representative” or “Portfolio Manager” and an “Officer” and Jane is a non-advising “Officer”. Oddly enough, most representatives, historically referred to as an “Financial Adviser”, will actually be licensed as a “Dealing Representative” associated with an investment dealer or mutual fund dealer, not as an “Advising Representative”.

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