FOURTH QUARTER LETTER 2008

FROM BURSTING BUBBLES, ANOTHER IS BORN

There is no doubt that 2008 will go down in history as the worst financial meltdown since the 1930's. The irresponsible lending and massive leveraging by intertwined global financial institutions, coupled with lax regulatory regimes worldwide, sowed the seeds of greed's destruction as the U.S. residential real estate bubble burst. As mentioned in our previous letter, the unwinding of leverage and the resulting unmerciful forced selling, has caused an unprecedented decline in valuations of nearly all securities in all sectors, starting with liquid large cap stocks and cascading down to smaller companies. Equity markets worldwide dropped between 35% and 70%. Fixed income instruments such as corporate bonds and preferred shares plunged as credit spreads widened to near historic proportions. Even the debt of certain governments has collapsed and the torrid rate of growth in emerging countries like China and India has slowed down dramatically.

There were few places to hide: The US dollar benefited from the repatriation of funds due to the liquidation of foreign investments and a perceived flight to quality. The Yen rose due to the unwinding of the carry trade which required the repayment of Yen denominated loans. However, now that yields on US government debt are near zero and even negative in real terms, another bubble has been created by this massive flow of funds. The hording of cash is a waiting game in the current deflationary environment. With no upside left to holding US treasuries (other than from prolonged deflation), and trillions of dollars to be printed to fund record deficits, debt and bail-outs, the US dollar has set itself-up for a potentially very hard landing. As with past sovereign debt crisis, the likely way out is to eventually devalue the US dollar. When that day comes, import and monetary inflation will sweep the land and interest rates will rise, crushing US bonds.

PUTTING THINGS INTO PERSPECTIVE

Few people foresaw the magnitude, speed and breadth of the credit crisis, as few realized just how levered and entangled the global financial system was. While capital has been permanently lost, mainly by those who purchased structured products backed by assets of questionable value and who bought shares in banks, brokers and insurance companies where trillions of dollars have been wiped-off of balance sheets forever, one must not lose sight of the true intrinsic value of good operating companies. The prices at which many companies are trading today on paper, does not reflect their true worth. One recent example is Dover Industries, Canada's 3rd largest flour miller and one of our core holdings. Dover is being acquired by a strategic buyer for 9.4 times trailing EBITDA, representing a 39% premium to the closing price that Dover's shares were trading at on December 4th. This proves that acquirers are still willing to pay a fair price for a good company. This is the 3rd company being acquired in 2008 at a significant premium in our portfolio, and validates holding positions over the long term until true value is maximized or the prospects of the company change.

It is also worth noting that record amounts of liquidity are waiting to be reinvested in the capital markets. With the US dollar and government debt having reached overbought levels as a temporary parking place, the hedge fund industry in shambles due to the Madoff scandal and complex illiquid investments being shunned including private equity, stocks will be the liquid investment of choice to achieve inflation-beating returns in the future. Pension funds and other institutional investors will also need to rebalance their portfolios by purchasing corporate bonds and in particular equities which bodes well for stock markets. Also, traditional portfolio managers running segregated accounts will be favored over pooled funds or structured products which lack transparency and are loaded with fees for the benefit of the financial institutions that fabricated them.

OUR OUTLOOK AND STRATEGY

We are no doubt in for a long and deep global recession, however this has been largely priced into most markets at this point. While we bounce off of a murky bottom, there remains a risk that the equity and credit markets sink further. However, with the massive coordinated government interventions in the form of quantitative and fiscal stimulus, industry bail-outs, infrastructure spending… some semblance of stability should return before the end of the year. Meanwhile, negative headlines will dominate in the form of higher unemployment, bankruptcies, and more bail-outs. However these are lagging statistics and when they peak, the economy will have bottomed and stocks will have begun to rise. With hedge fund selling and mutual fund redemptions waning, market volatility will gradually abate. Meanwhile the massive and globally coordinated government initiatives to stimulate economies and encourage banks to lend will gradually take effect. While impossible to time the bottom of the market, remaining invested is the only sure way to benefit from the eventual recovery.

Despite the decline in share prices, many of our portfolio holdings continue to grow and generate record profits while paying healthy dividends or distributions. Many are even increasing payouts to shareholders or making special distributions such as Telus, Shaw and Vicwest, as well as many of our utility holdings. Nevertheless, one must be more selective than ever in holding companies that will not only weather the economic downturn, but will come out even stronger in the end. This requires having an appropriate mix of companies, which remain, to the extent possible, insulated from the US consumer and credit problems. This implies remaining underweight banks and consumer discretionary companies that export to the US, and avoiding highly leveraged companies. We also continue to be overweight in defensive sectors such as utilities, through core holdings such as Fortis, Transcanada Pipelines and Caribbean Utilities.

Our strategy going forward is a multi-faceted one, positioned to balance stability and growth, and benefit from a rebound once economic recovery is underway:

- **Buying credit opportunistically:**

  We have been adding to our fixed income weighting by opportunistically purchasing shorter maturity corporate bonds and preferred shares in high quality companies at very attractive yields, taking advantage of motivated sellers as they present themselves. Examples include Loblaw's, Shaw, Rogers and Transalta. Bonds spreads have already began to narrow, which is usually a precursor to a market recovery.

- **Getting paid to wait:**

  We continue to hold companies with solid balance sheets that generate strong free cash flow and are rewarding investors meanwhile through dividends and distributions. These include communication and media companies, utilities, selective Canadian banks, royalty and business trusts, and special situations. Yields are high and the potential upside from depressed valuations on the underlying equities make these attractive investments. History has shown that investors are rewarded buying equities during the rare periods when dividend yields on stocks are higher than the yields on 10-year government bonds.

- **Owning “defensive growth” and special situations:**

  We continue to hold and look for defensive domestic companies that have growth characteristics such as Shoppers Drug Mart, Tim Horton’s, Shaw, Glacier, Corus, Astral, Arbor, and MTY Foods; have record backlogs such as Calian and Velan; are cash rich and hold valuable assets such Wi-Lan, Mosaid and Neo Materials; or will benefit from infrastructure spending such as Stella Jones and Logistec. We also expect merger and acquisition activity to pick-up, as industries seek to consolidate and low valuations attract strategic buyers, which should help prop-up stock prices.

- **Reducing US dollar exposure:**

  Given our long term bearishness on the US dollar, we have been using US dollar strength to reduce any remaining US investments and convert the proceeds into Canadian dollars.

- **Building a store of value:**

  We have been building a small weighting in the gold index, as a potential store of value against the decline of paper money. On a relative basis, gold is the commodity that has held its value the best versus the US dollar during 2008. Eventually, as the US dollar drops and inflation returns, the value of hard assets will appreciate significantly, especially when demand for commodities picks up again from the resumption of growth in China and India. In the resource sector, we favor increasing our weighting to energy stocks on weakness. The supply of cheap oil is limited and once OPEC’s production cuts take effect and the demand destruction abates, this sector will rebound sharply. We like the prospects for uranium due to the increasing number of nuclear projects planned worldwide coupled with potential supply constraints, which we will benefit from through our investment in Uranium One and Velan. We also favor agriculture related stocks such as Potash and Viterra, as food supplies will remain a top global priority.

In summary, we feel that the market is going through a bottoming process, and that current valuations are compelling for investors with a long term investment horizon. We continue to focus on growing domestic companies with strong balance sheets and defensive characteristics, along with a prudent weighting in banks and resource companies which should rally ahead of a sustained recovery.

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