Investment Commentary

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Summary 2006

2006 was a very good year for global stock markets with emerging and developing markets performing best, propelled by higher growth rates and commodity prices. North American stock markets put in solid gains. The S&P/TSX index was up 17.3% while in the U.S., after two years of lackluster returns, the S&P 500 index advanced 15.8%.

It was a relatively disappointing year for the bond markets. The Scotia Capital Universe index which serves as a broad measure for Canadian bonds posted a return of just 4%, as interest rates held steady.

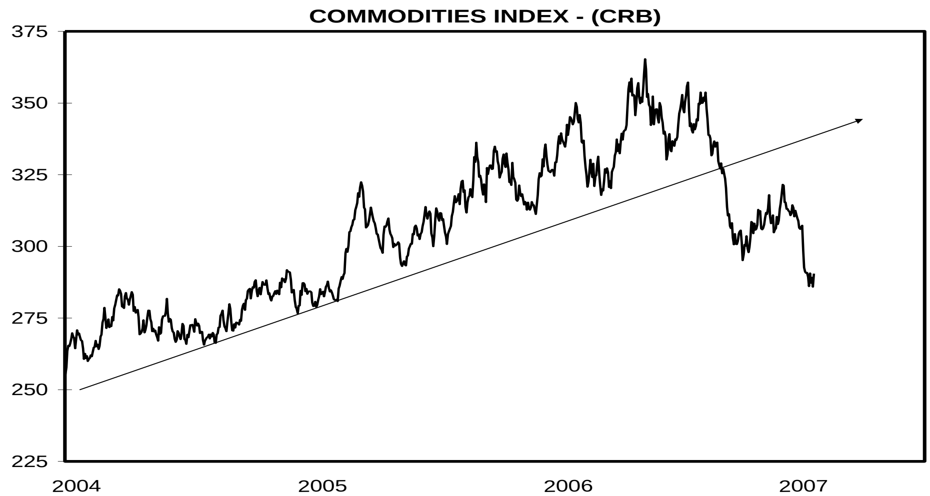
The big surprise of the year was a reversal of fortunes in the price of oil. With early expectations of oil reaching $100 per barrel, it ended the year down at $61.05 and has continued to weaken in the early part of 2007. Prices of all commodities were very volatile. Gold bullion peaked in the spring reaching $714 in U.S. dollars and then fell quickly to $559. It closed the year at $638.

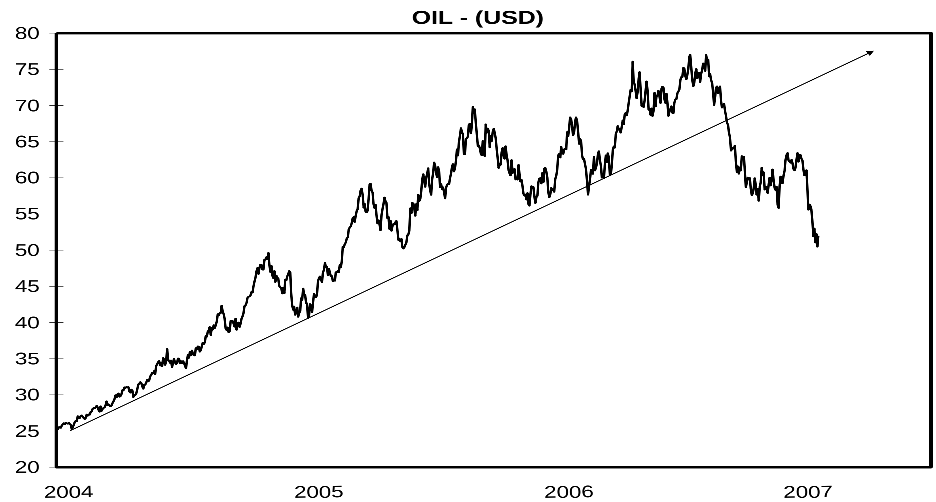
Our Loonie declined marginally in 2006, in U.S. dollar terms, ending the year at 85.81. It dropped from peak levels due to weakness in oil and a decline in our trade surplus.

Commodities

The three year uptrend for commodities and oil appears broken. Whether the three year rise in commodity prices was speculative or completely valid on economic grounds, this break in trend is important going forward. If the uptrend was mostly speculative then a trend reversal is now in place and we can expect much lower prices. This would not be good news for the resource dependent

Canadian stock market. If the rise was based mainly on economic grounds, then the break in trend is not likely to be permanent. Rationally, both factors, speculative and economic, have contributed to the rise in prices. The sharp volatility, while startling, should not have been unexpected. With a substantial sum invested in commodity related funds, the financial markets are now highly influential in setting prices. Ordinarily a break in trend of this magnitude would be the signal of a major global slowdown. While there is undoubtedly some concern, the demand for commodities from emerging and developing countries, namely China and India, continues strong. With impressive economic growth rates likely to continue, we would expect commodity

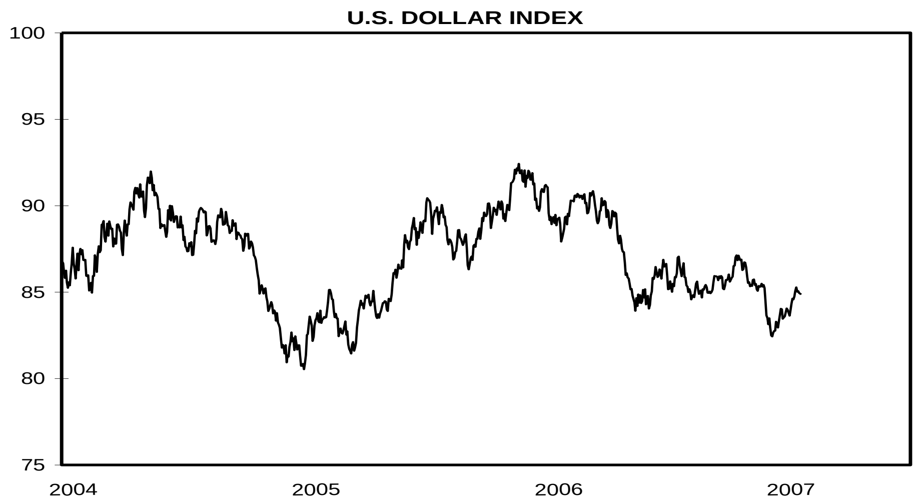




prices to strengthen over time. Needless to say, monitoring commodity prices will be important going forward.

Over the past three years numerous comments have been made suggesting the price of gold bullion is positively correlated to the price of commodities, especially oil, and negatively to the U.S. dollar. As can be readily seen by the above charts, there is no *direct one-to-one correlation*. The price of oil or the movement of the U.S. dollar may at times *partially explain* a move in gold, however the evidence shows gold to be fairly independent of the other two. The price of gold languished in 2004 and for most of 2005 while the price of oil almost tripled. Importantly, the latest sharp decline in commodity prices did not have a lasting effect on the price of gold. Oil is down over 30% from its peak while gold is down just over 10%. The U.S. dollar over this recent period *declined modestly* and during the big move in gold which began in the third quarter of 2005, the U.S. dollar *effectively went sideways*.

Volatility will likely continue. We expect the price of gold to rise independent of other commodities and independent of the U.S. dollar. Should the U.S. dollar weaken and/or the price of oil stay high, the advance in the gold price would only be enhanced.



Leverage

We have often written about the huge level and seemingly endless supply of debt. The use of leverage, or borrowing, is considerably higher today than in previous economic cycles. Ratios such as debt to GDP and debt to personal incomes are at or near record levels. Whether intended for housing or for speculative activity in the financial markets, *borrowing vast sums of money will always drive underlying asset prices higher*. Extreme valuations or "bubbles" are then made possible as higher prices encourage more investors to join the party - throwing caution to the wind.

Will leverage be the norm and become a permanent fixture in the financial landscape? If so, fundamental financial analysis will need to adapt and begin valuing investments and managing portfolio risk with a new mindset – *one that accepts higher prices and more volatility*. Leverage cuts both ways. Hedge fund managers can borrow extensively and profit from markets going up or down.

The use of leverage, not only inflates valuations, it also skews relationships. Older correlations breakdown and new ones emerge, often for only very short periods of time as managers hedge positions. While we may have entered a brave new world, the use of leverage may also be temporarily camouflaging what is really going on in the economy. The rise in the U.S. stock market is at odds with a deteriorating economic backdrop and weaker consumer spending. Awash with liquidity, the financial markets don't care and are busy chasing trends. What happens when the markets turn sour? As observed last spring, declines are sharp and violent.

Importantly, Wall and Bay Street have designed financial products aimed at developing investment strategies in order to mitigate risk. While theoretically sound, only time will tell how risky these products are. This kind of financial engineering has led to numerous disasters in the past. In 1987, "portfolio insurance" was designed to protect institutional investors in the event of a market correction. Instead it was the primary cause of the infamous October Crash. A form of insurance is being replayed today in the hedge fund universe. Using derivative products the hedgers feel they are safely protected from a major decline in the markets, or at least they can, easily and inexpensively, act quickly should the markets spiral downwards. Yet time and again, as is characteristic of all auction markets, when it comes to sell liquidity can no longer be relied on – buyers all of a sudden disappear.

If a large bet is being placed by institutional investors and hedge funds that they are "protected" or can exit markets at a moments notice, then this very behaviour is certainly influencing market prices.

Bonds

The use of leverage is also alive and well in the bond market. Credit derivatives are the latest product of choice. Essentially, a form of insurance for bond investors, it allows speculation in the "junk" or low quality credit market, where yields are higher, with the promise of capital protection. Riskier loans are thus turned into quality credits. It is the equivalent of creating a silk purse out of a sow's ear.

These derivative products have forestalled the widening of credit spreads normally observed as the economy slows. Higher interest rates on poorer quality fixed income securities can signal the beginning of a credit squeeze. The resulting contraction in liquidity would then send bond prices lower as yields rose. Not so this time – at least not to the same extent. Derivatives and all the associated "hedge" products allow risk to be broadly diversified away. The fact these products may be distorting fixed income markets and keeping interest rates lower than they might otherwise be is rarely discussed. It is actually impossible to know with any precision the dollar amounts involved and the larger effects on markets. Many of the biggest bond managers simply hold to the conventional view that a slower economy will bring yields down and therefore bond prices up.

When credit losses begin to mount the market for credit insurance will be tested. There is risk of it unraveling as investors offload their positions. Who will take the other side of the trade? When market conditions suddenly change the exit door may be too small for all to get out at the going price quote. A rise in interest rates is certainly a possible outcome.

A Central Bank's job is to prevent the excessive supply of money and credit during the expansionary phase of the business cycle. In this regard the U.S. Federal Reserve has done a poor job as they have watched and encouraged an expansion of credit at an unprecedented pace. If and when liquidity finally tightens it will usher in an old fashioned credit squeeze. So far, an unlimited supply and a cheap source of financing is still available. Markets will remain distorted until this changes.

In all likeliness, the bond market may have already priced in a weaker economy. If the economy strengthens more than expected, bond prices are likely to sell off. More recently, inflation has surprised on the upside and the core rate is stubbornly at about 2.5%. For that reason we see little room for yields to decline. As a result, for balanced accounts we remain positioned in shorter term bonds where the risks are very low.

Real Estate

It appears that many more optimists than realists are predicting the U.S. housing market has bottomed. Additionally, they insist a decline in interest rates will resurrect the industry. History paints a very different picture. The industry usually peaks at about 6%. House prices typically bottom a few years later when activity is closer to 3% of GDP – when contractors are making sales calls!

The current residential housing cycle has been extended a few years due to the lowest interest rates on record. The dramatic rise in house prices has been out of proportion to the growth in wages and salaries and to rental incomes. Credit standards were loosened and innovative financing flourished, i.e. adjustable rate and interest only mortgages. We now see a change as credit standards tighten and mortgage rates are adjusted upwards. Mortgage lending is shrinking, as the desire to buy or speculate on housing declines. Like all asset bubbles, when they start to deflate, momentum usually takes over.

Conclusion – The decline in the U.S. housing market will likely be prolonged, especially in the once "hot" regions where speculative activity was more intense. In Canada, we can also expect a slide, although the magnitude is certain to be less as our markets were never as overheated.

Strategy

This past year has witnessed a level of volatility not seen in many years. There is uncertainty in the marketplace and emergent fears of monetary inflation brought about by the chronic fiscal deficits in the U.S. Positioning for a possible mania in the price of gold makes sense, although the market may not necessarily cooperate immediately. A trading strategy will therefore be more appropriate this year, both in an attempt to augment portfolio returns and to protect capital in the event of declines. These declines can be steep, as we saw with the price of oil. *In the shorter-term*, there is reason to believe the same can happen to gold.

Now that the myth of permanently rising prices in the housing market has been exposed, investment dollars will focus their attention elsewhere. It is very likely that gold will be the recipient of investment dollars *over the longer-term*.

On an historical basis stocks remain expensively priced. If there is no further deterioration in the slowdown in the U.S., perhaps the only risk is a mild correction in prices. With stocks priced for perfection the risk level is higher than average. Should the slowdown turn into a mild recession later this year prices could fall significantly. It is often said the markets "climb a wall of worry". From our perspective, it is easier to stop worrying when prices are cheap and there is considerable room for the unexpected. This is not the case today. Accordingly we continue to recommend less than fully invested positions in the equity markets.

The U.S. dollar continues to be vulnerable. OPEC nations are reported to be selling U.S. Treasury bonds as the price of oil tumbles. Over the years they have accumulated a large amount of these "petrodollars", earned from record-high oil prices. The combination of reduced petrodollars and China's efforts to diversify its massive pile of foreign reserves is going to be a challenge for the U.S. dollar in 2007. The Canadian dollar will likely fair better but it too may be caught up in the crossfire.

Stronger economic fundamentals in Asian and other developing markets may accelerate a shift out of U.S. and Canadian assets. Foreign currencies are likely to remain strong, further supporting a shift in investment dollars. Canadian markets have benefited from a near tripling in the price of oil (at peak levels). While the environment for resources overall should still remain positive, diversifying partly out of Canada is a prudent longer-term investment strategy. We have done so with investments in Japan and Hong Kong and will look to making investments in other international markets going forward.

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