REVIEW & COMMENTARY
1ST QUARTER 2007

Waiting for Good-t'-go

It seems every quarter or so, there is a new threat to the equity markets. Recent culprits include carry trades, hedge funds, geo-political tensions, and inflationary/deflationary fears. However, the sinister sounding "sub prime" threat has become the most recent culprit and blamed with this quarter's volatility, deservedly or not. One thing that has become evident, to us anyway, is how this volatility continues to paralyze investors- many toward withdrawing to the sidelines and waiting for a better opportunity. While some investors target lower valuations or simply better prices, this is a version of market timing and it rarely works. Violent market swings occur with increasing regularity. Trying to anticipate them or trade around them is difficult. Instead, stay the course and use them to enter or build positions in a conservative diversified portfolio and volatility can always be tempered with fixed income.

Sub prime mortgages are a threat, but overvalued real estate and leveraged buyers is nothing new. Foreclosures and bankruptcies of overly aggressive lending institutions are increasing. And it is not only a "Made in USA" phenomenon- a major Canadian Bank only a year ago was advertising that they had the perfect mortgage for those who could not afford a down payment. Similar conditions were evident in the UK well before it became so well known in North America. Real Estate prices are off in both North America and the UK and some borrowers bruised, but life hasn't ended and the economy adjusted. This will happen in North America as well.

Sub prime statistics are imposing. According to the Economist, a recent survey shows that over 7% of those who had taken out a mortgage in the last two years had no equity, or less, in their homes. 87% of those who had taken an adjustable rate mortgage (ARM) between 2004 and 2006 had less than 30% equity in their homes and the interest rates charged on these mortgages are due to start "adjusting" in 2008. Given that housing wealth accounts for approximately 20 trillion dollars in the US, it is not hard to see why many are quite anxious about the economic repercussions if the real estate market continues to slow.

One problem is that modern media provides a forum where bad news sells better than good news. When a certain theme resonates, it gets attached to an investors psyche. Every time the market swoons, the news media have to attach some menacing underlying reason to justify the sell-off. While it may be reassuring to understand causal relationships given the complexity of the markets, it is hard to isolate one factor- as if any one person would know anyway. The history of investing demonstrates that there are periods of above average returns, followed by periods of below average returns. These retracements, decades ago, could take several months or

even years to complete; now they frequently take a few days or weeks. Given that we have experienced both, we feel that while the violence of these modern day sell-offs are much harder to stomach, they are preferable to a monotonous downward trend over several years. Sharp declines are unnerving, but many of us have been through much worse. Remember October 1987? - a 22% drop on the Dow Jones Industrial Average in one day! While we haven't had a downturn that dramatic since, the frequency of swings in the equity markets has increased. Most recently world markets swooned after a dramatic one day loss in the Chinese equity markets.

International investing has become increasingly topical and many institutions are encouraging people to invest more abroad. Although we are well aware of the fact that the North American markets represent a declining proportion of the world market, it still is home to many companies of proven quality and outstanding economics. About a month ago, the Chinese equity markets fell by 9% in one day. North American markets quickly followed by approximately 4% in the following two days, demonstrating that global markets are becoming increasingly correlated. One of the benefits to investing abroad has been the relatively low correlation to North American markets, but as this correlation grows more positive, international investing, particularly emerging market investing, becomes riskier. When the correlation argument is factored out other risks such as increased volatility, lower liquidity, inferior accounting & reporting standards, and currency risk become more influential. These are not risks an investor should underestimate- especially currency risk. It is not to say that individuals should not invest internationally- it simply means that there are many ways to do it. Some are less aggressive than others. Investing in North American equities that have international product lines is one we prefer.

But for those who are waiting or are unnerved, there are several positives that rarely find enough air time. SIM was asked to speak on ROBtv, now BNN, the day after the Chinese equity sell off. We spoke about looking to the markets for opportunity rather than with trepidation. There were opportunities but caution is always paramount which is why we urged that if you invest in quality companies you will get the best long term results. The other positives in the market are that interest rates are still low. For price earnings multiples to drop dramatically either interest rates will have to go up significantly or the market will deride the quality of earnings being posted by corporations. With Sarbanes-Oxley is it hard to believe that the quality of these earnings will diminish? As well, liquidity is very high. International resource companies covet our resource companies and there have been close to a dozen announced takeovers of income trusts in the past quarter. Even BCE is rumoured to be a target. If private equity is suggesting that we are undervaluing our equities that much, then maybe we should all listen. Canada is an attractive place to invest so if you are on the sidelines, don't wait for the 'good t' go'!

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