

Two Questions – When & What

Ms N. and Mr M. are financial consultants whose views and questions we respect. They have asked us two posers during recent client presentations – Ms N. asked, “When will it end?” and Mr M. asked, “What could make you wrong?”

“When will it end?” An answer for the equity markets could be, “Maybe now, maybe December”. As we approach the grim winter solstice, our shortest day and longest night, the Toronto and New York markets appear to want to bottom. After the conference of Group of 20 Nations in Washington on November 15, both markets began an erratic appreciation.

We think the stock market may find some cheer this holiday season. The cessation of year-end, tax-loss selling, the cornucopia of interest rate cuts, tax cuts, and spending plans announced by the Group of 20, the support of book value for many shares trading at a discount to book, and the anticipation of the Barrack Obama Presidency and his massive stimulative plan, may offer investors some hope.

The bond market is supportive. Interest rates by design provide no competition to equities. Dividend yields for many companies exceed Canada bond yields by a wide margin. The authorities are frightened and inventing new medical treatments daily.

In our short-term hope for calmer equity markets, we hold no illusions. Equities may only enjoy a year-end rebound. We know after a year of treasury and central bank financial band-aids, business wounds are still bleeding profusely.

The wisdom of stimulating consumption after seven years of indiscriminate stimulative fiscal, tax and monetary adrenalin in the U.S. bedevils us. We think it unreasonable to assume the policies that corrupted the financial system and business cycle will save it. Savings are missing and negligible interest rates will not promote the liquidity needed to rebalance the banking system.

We know deathly economic and financial news is coming in 2009. Commodity prices and house prices are falling. Copper and oil dropped to new lows this week. Today Merrill Lynch forecast a \$25 per barrel price of oil next year. November U.S. retail sales fell 2.7%, the worst showing in 40 years. U.S. manufacturing orders declined the most in the past 50 years. Lending is falling. Layoffs are rising. Profits are falling. The credit crisis has halted lending and spending.

Pooled Fund – Month End Unit Values

Unit Values	Dec - 07*	Sep - 08*	Nov - 08
Cdn Income Fund	10.23	10.27	10.38
Cdn Balanced	13.72	13.16	12.44
Cdn Equity Fund	10.37	9.59	8.44
Cdn Small Cap	23.28	19.29	15.19
Global Equity Fund	8.96	8.37	8.23

** Post distribution*

The over-bid bond market, near-zero interest rates and the endless schemes and plans to salvage financial institutions and borrowers tell us the banking system is still frozen. To date the implosion of global debt is crushing the prop up schemes contrived in Washington. No lending equals no economy.

While, we make a case for some short-term bounce from stock market lows, the seizure of the banks on Bay Street will stun citizens on Main Street into savings, not spending. The economy is decelerating on the downside. Therefore, despite the massive decline in share prices, we are convinced equity prices can go much lower, to a point where the S&P/TSX will discount its book value of 6,000.

According to a screen run by CPMS, 80% of Canadian stocks now trade at a discount to book value or invested capital. The market, as measured by the S&P/TSX Composite Index, does not, as the Toronto market index is weighted heavily to some bigger companies.

The market trades over 1.3 times. Larger companies still trade significant premiums to book value. These companies, notably the banks and energy companies, face much lower profits next year. They will see lower share prices and as these companies carry the heavy weight on the Toronto stock index, we see lower lows in '09. So, Ms N. we think, “We are not *there* yet. It will end next year.”

The second question from Mr M. was, “What could make you wrong?” Well, we at QV have invested heavily anticipating the deflationary credit bust. A reversal of that proposition would make us wrong.

“What could make us wrong?” We could be wrong Mr M. if the corrective actions take hold and banks begin to lend and consumers begin to spend. Low interest and low oil prices may give the consumer confidence to borrow and that might crank up the price of everything and the commodity and equity markets.

With Canada and US bonds offering no real interest rate, we could experience rampant inflation. Our low commodity and high bond exposure would hurt us. For now, we argue the crumbling of the world's debt, now far in excess of its collective Gross National Product, undercuts the inflationary thrust of sovereign interest rates priced practically at zero. While Treasury Bills are at zero, the cost to the average borrower is much higher. Deflation is the force for now.

Mr M., another way we could be wrong is if the world turns against lending to the U.S. and of necessity, their short rates begin to rise dramatically to attract creditors, to attract money to fund their deficits. In that case, we would all be in difficulty. This is the present situation in Iceland.

As for bonds, we have shortened term in the Canadian Income Fund and have increased cash reserves there. Interest rates are so low, we worry there is no way to go but up especially in bonds with very short terms to maturity.

Inside the Portfolios

We have taken some pre-year end action to limit capital gains by selling positions in our two Canadian Equity Funds. In the Canadian Small Cap Fund, the Canadian Equity Fund, in our Canadian Balanced Fund, and in established segregated portfolios where we have realized capital gains earlier in the year, we have taken losses to reduce capital gains.

In the Small Cap Fund, we aggressively added to strong companies we felt would endure in the recession and we eliminated weak companies, thus we have reduced the number of holdings to 36.

In the Canadian equity portfolio, we sold two companies, Teck-Cominco, the mining company, and GMP Securities, an investment banker and broker. We have tried to minimize capital gains realized on the sale of Canadian Oils Sands Trust, by taking these losses. We will review these companies in the New Year. We will consider replacing the positions after the 30-day wait period.

In the quarter, we have introduced RIM – Research in Motion, a well known Canadian maker of proprietary communication devices or Blackberry's. RIM carries no debt. Their innovations continue to enter the market and demand continues to grow albeit at a lower pace than over the past few years. In US dollars, RIM traded over \$140 per share one year ago. Today, RIM trades at less than \$40 per share. The equity now offers some semblance of value. For the long term, patient investor, RIM offers an attractive return. RIM pays no dividend.



Total Return – Capital Gains plus Income (%)

To Nov 30'08	1 Mo	3 Mo	1Yr	3 Yr	5 Yr	10 Yr
QV Pooled	%	%	%	%	%	%
Cdn. Income	1.0	0.5	4.9	4.5	4.8	5.0 ⁺
Cdn. Balanced	-1.3	-10.1	-6.3	2.1	5.6	9.3
Cdn. Equity ⁺	-5.2	-18.9	-16.1	0.6	8.6	14.2
Cdn. Small Cap	-11.0	-30.9	-31.2	-3.4	6.8	13.1
Global Equity	-2.9	-4.9	-7.7	-	-	-

⁺ Historic equity returns from the Cdn. Balanced Fund [^]6 years

Benchmarks:

DEX Bond Univ.	2.4	-0.4	4.1	4.0	5.3	5.8
Balanced Fund	-1.3	-16.1	-14.3	1.4	6.0	6.2
S&P/TSX Comp	-4.7	-32.1	-30.3	-2.6	5.7	5.9
BMO Small _{unwtd}	-11.5	-48.1	-52.2	-17.7	-6.8	1.1
MSCI World _(SCA)	-5.1	-22.7	-31.5	-8.4	-2.7	-4.1

⁻ Pooled fund returns are gross of management and custodial fees. Returns over one year are annualized.

⁻ The Balanced Fund Index reflects the total rates of return earned by the DEX 91-Day T-Bill Index (5%), the DEX Bond Universe (45%), the S&P/TSX Composite Index (40%), and the MSCI World Index (CS) (10%)