2011 Year-End Report: Focus on What's Important

The U.S. economy remains almost comatose… The current slump already ranks as the longest period of sustained weakness since the Great Depression… Once-in-a-lifetime dislocations… will take years to work out. Among them: the job drought, the debt hangover, the defense-industry contraction, the [banking] collapse, the real estate depression, the health-care cost explosion and the runaway federal deficit.

- Time Magazine

Clearly the U.S. and the world have issues that will take years to resolve. There is no disagreement from us here. We are in an era today where we face deep and structural problems that will require time to correct. The main problem today, however, is the same one that investors frequently face—a lack of perspective.

Is the proverbial glass half full or half empty?

We will only ever know this in hindsight, but as the top quote indicates the way out of this current malaise is unclear. In fact it is as unclear as it was in 1992 when the quote was written in Time Magazine! Yes, that is correct, the quote above is from 1992.

Deleveraging: The process of paying down one's debts.

The world has been in a cycle of increasing indebtedness for the last 30 years culminating in the credit collapse of 2008. This debt buildup manifested itself in real estate, however the effects of it were far reaching—as we all now know. This debt buildup was not a new occurrence, but simply a repeat of longer-term boom bust cycles. These cycles arise because investors move from a state of fear to one of greed, where risk management becomes a swear word, due diligence falls by the wayside, and investments are made not simply on merit but on the fear that if one does not invest they will "miss out".

This same debt story was played out in 1907 and 1929 as debt levels fuelled by easy credit grew. This turned investors into speculators, where debt levels mushroomed to unsustainable levels and the stock and real estate markets crumbled. The 2008 cycle was compounded by the loose monetary policy of world governments that encouraged borrowing with artificially low rates and excess government spending and borrowing.

Now, much like the aftermath periods of 1909 and 1932, in 2012 we are faced with a scarred population that is seeking to reduce debt to more manageable levels.

What does this mean for the world?

Less debt or less leverage in the system means a headwind now develops as leverage is pulled from the system. Consumers and businesses are less willing to be levered and need to minimize any existing leverage—they are more comfortable reducing rather than increasing debt. In an environment like this, investing with a focus on yield does become important, but it shouldn't come at the expense of neglecting valuations.

Like yields, valuations also become more important during an era of deleveraging. So an investor would be well served by thinking like a business owner and investing where yields are above market and sustainable, where valuations are fair and offer a margin of safety and to have multiple asset classes to deal with different market outcomes.

Top Performing Equities per Strategy

Income
- KEYERA CORP
- LAURENTIAN BANK OF CANADA
- TELUS CORPORATION
- METRO INC
- COGECO CABLE INC

Income & Growth
- KEYERA CORP
- TELUS CORPORATION
- HOME CAP GRP INC
- METRO INC
- LAURENTIAN BANK OF CANADA

Moderate Growth
- TELUS CORPORATION
- NEWMARKET CORP (HLDG CO)
- METRO INC
- CORUS ENTERTAINMENT INC
- DELUXE CORP

Growth
- NEWMARKET CORP (HLDG CO)
- TELUS CORPORATION
- METRO INC
- CORUS ENTERTAINMENT INC
- DELUXE CORP

Active Growth
- KEYERA CORP
- NEWMARKET CORP (HLDG CO)
- NEO MATERIAL TECHNOLOGIES INC
- SINCLAIR BROADCAST GRP INC
- DELUXE CORP

Dynamic Growth
- The strategy was in cash at the end of December 2011.

Unfortunately, yield seems to be the trend today as investors pay no regard to valuation and seek yield regardless of price. This is the biggest danger in today's low interest rate environment. Investors frustrated with low rates reach for apparently attractive yields and stretch themselves out unknowingly on the risk spectrum. This always ends badly for the investor and this is why It is imperative that investors acknowledge their goals and risk profiles and invest according to their personal plan.

What are the potential market outcomes from this environment?

In a low interest rate environment accompanied by deleveraging growth rates are expected to be low; accordingly, nominal return expectations (returns before subtracting out inflation) should be lowered. A nominal return of 3%-5%, where inflation is -1%, is still a healthy real rate of return of 4%-6%. Although not exciting at first glance, this would compare favourably to a nominal rate of return of 8%-10% when inflation is 4% because the real rate of return is still 4%-6%.

The dilemma today is that governments around the world continue to manipulate monetary policy and tilt the deck and if they succeed in creating inflation the game will change. This is why we believe it is prudent to have offsetting strategies for investment that can deal with both outcomes. Investments that will do well in an inflationary environment are real estate, commodities, commodity stocks, and companies with pricing power.

Finally, and most importantly, an investor would be well served to invest capital based on his or her need for that capital as opposed to prevailing investment trends.

What does this mean?

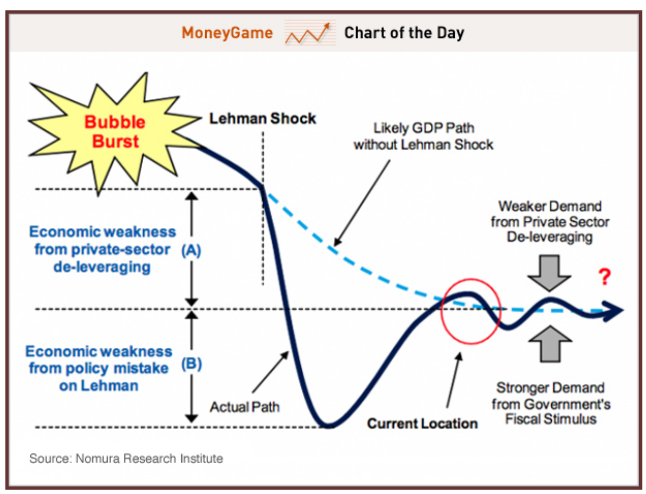
An investor with funds that he or she does not need for 20 years could buy a rolling five year GIC with a current yield of 3%, or they could invest in a basket of high-quality companies that have growing profits and dividends and compliment those stocks with some quality bonds. They could receive a yield of around 3.5% and in all likelihood see the dividends increase on those companies over the next 20 years, just as they have for the last two decades. *If* they can think like a business owner and ignore the day to day fluctuations of the market price of these businesses (just like we do with our home price) they should have some capital growth over time as well.

Now, an investor might say that they do not have 20 years to invest because they need immediate income or they are retiring in five years, or sometime in the very near future. However, even if these things are true, only some of the capital will be required for current income and some of the capital will not be used for five years or longer. So an investor should have a long-term perspective with some of their capital and some of their capital should have a short-term perspective.

These two points are essential to making the critical foundational decisions of where and how to allocate capital so an investor can withstand the inevitable temporary market fluctuations that are part of any and every market cycle.

In this market we like dividend paying stocks, we like high yield bonds and investment grade corporate bonds, and we still like gold as governments around the world print money and devalue paper currencies. Finally, we like emerging market dividend stocks that yield 6%+ and benefit from global economic growth.

In saying that, make no mistake, the last few years have dislocated the system, but the system is recovering. Rail car loadings have reached new highs, credit card delinquencies are at record lows, real retail sales are on track to rise an annualized 7% quarter over quarter, unemployment claims are falling, and earnings are growing. With this good news though, we do face the headwind of deleveraging, which is shown by the chart to the right.



Governments around the world are trying to offset the weaker demand that is coming from the private sector. In doing that we have seen volatility in the markets that is profound and exhausting to most investors.

We believe that investors will be well served in this environment by doing the following:

1. Understand your goals and objectives
2. Sensibly allocate your capital based on these goals
3. Own quality and pay a *fair* price for it
4. Ignore the media hysteria of the day, they are here to get your attention and sell advertising, not to educate

We encourage investors to be mindful of their goals, risk profile and portfolio allocations so they are able to benefit from positive surprises that may occur, yet also be able to weather financial surprises that may negative. We do the same in our portfolios.

We wrote the following in June 2011:

"Will there be stock market volatility, a sovereign debt crisis somewhere when a government eventually defaults on its debt, or another unknown that scares investors? Absolutely!"

As we now know, these concerns have come to pass. Yet just like the quote from 1992 that we began with, there are always and will always be issues to contend with and just like the problems of 1992, we did get through it.

We thank you for your continued trust.

R&R Investment Partners

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Vice Presidents, Portfolio Managers
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