CIBC Wood Gundy

Macro-Economic Indicator Review

I have been monitoring various macro-economic indicators closely to determine whether signs of a recovery would be validated, but the picture has recently turned negative. Therefore I have materially increased the allocation to cash in the Total Return Portfolio to over 35% by taking profits on certain investments that have appreciated greatly since being added in early 2009.

I believe there is roughly a 50% chance that North American stock markets decline over the next two quarters, which could create opportunities to redeploy cash into undervalued investments. In order to generate satisfactory returns in a potentially difficult market, I plan to make opportunistic buy/sell decisions and keep a portion of the Total Return Portfolio invested in securities with above-average yields.

A three-year chart of the TSX Composite Index is shown below. Note that the Index has struggled to continue its upwards trajectory over the past three months.

Macro-Economic Indicators

While I do not make investment decisions based on any single macro-economic indicator, deterioration in several is something that I cannot ignore. As discussed in previous editions of this newsletter, the objective of preservation of capital is important to me and that is why the risk in the Total Return Portfolio must sometimes be reduced. Unlike the vast majority of mutual funds or asset management companies I believe that above average long-term returns are very attainable without being 100% invested in equities 100% of the time. Holding cash is a portfolio management decision and it is a decision I am very comfortable with currently.

U of M Consumer Sentiment Index (CSI)

The University of Michigan's Consumer Sentiment Index (CSI) fell by 9.5 points between June and July, which is the largest drop since October of 2008. The magnitude of the drop may be significant, as it has only fallen by 9.5 points or more on six other occasions:

- October 2008: The month after Lehman Bros. collapsed;
- October 2005: The month after Hurricane Katrina hit;
- September 2001: The month terrorists attacked America;
- August 1990: The month Kuwait was invaded; and
- March 1980: The month the stock market plunged and confirmed that the nation had entered a recession.

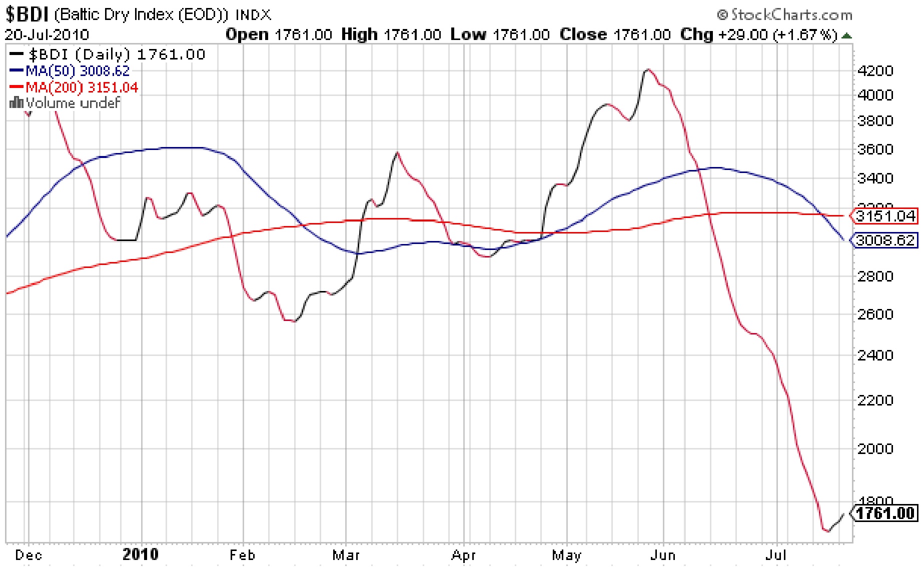
The current drop is just the second time in history (the other being 1980) that the CSI has fallen this far without being accompanied by a historically significant event. U.S. consumers are becoming fearful that the economy is not recovering, and lower consumer spending in the U.S. will likely translate into weaker overall economic results.

US Weekly Leading Index (WLI)

The Economic Cycle Research Institute (ECRI), a New York-based independent economic forecasting group, has created a proprietary Weekly Leading Index (WLI) that is intended to forecast future U.S. economic growth. Whenever the annualized growth rate of the WLI has dropped below minus 10% in the past 42 years, the U.S. economy has always gone into a recession. Recently the annualized growth rate of the WLI dropped to minus 10.5%. Despite this indicator, the ECRI has not yet publicly predicted a double dip in the U.S. economy.

The Baltic Dry Index (BDI)

The Baltic Dry Index (BDI) is an index created by the London-based Baltic Exchange that tracks the cost to ship various dry bulk cargoes around the world. When the BDI is rising, it indicates that the economy may be improving, as the demand for dry bulk cargoes and the ships to carry them is rising. Recently the BDI has been falling sharply, as shown in the chart below.



In 2008, this index declined by 94% in tandem with the market collapse. Recently it fell for 35 straight days. One criticism of the BDI is that a recent glut in the number of new ships delivered into the shipping market may be suppressing its performance and reducing its predictive value. I am well aware of the pitfalls of relying on any one indicator, and I consider them all only in the overall context of the economy and the markets.

I mention the CSI, WLI and BDI here because they suggest a trend towards weaker economic performance that responsible investors should carefully consider.

Trading Summary

Over the last quarter I have executed my plan of increasing the overall cash position in the Total Return Portfolio and taking profits on certain positions where appropriate. I sold Vale SA, Central Fund of Canada and Husky Energy at a profit (and I may repurchase these high-quality companies at lower levels, if the opportunity arises). I have also sold another 30% of portfolio's Silver Wheaton Corp. position at $21.70, which is an excellent result, as the most recent purchase of the stock had been made under $11.

I also made one small new investment in Synovus Financial Corp. Synovus owns 41 community banks throughout the southeastern U.S. It trades on the New York Stock Exchange and has a market capitalization of roughly US$2 billion. Like most US financial companies, Synovus has struggled since 2007 and has been forced to write off a large number of non-performing loans against its income. Needless to say, we are buying the stock at extremely depressed levels. I believe that Synovus can return to profitability in the 2012-2013 timeframe, and that our low initial purchase price (marginally below book value) provides a margin of safety while we wait. Realistically speaking, it may take a couple of years to determine if this thesis is correct.

Conclusion

I believe I am taking the correct proactive steps to manage the Total Return Portfolio in the current environment. Long-term clients will know I am non-dogmatic when it comes to my investment decisions, and that I will be ready to act (or stand pat, as appropriate) based on new developments. As always, thank you for your business!

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