Realizing Gains Where Warranted

Famous value investor Warren Buffett once said that rule no. 1 in investing is to never lose money and rule no. 2 is to never forget rule no.1. Now clearly with equity investing there is always risk of loss, but the meaning of his statement, which is to focus on capital preservation first and capital growth second, is an important lesson for today's markets.

The Canadian S&P/TSX Composite Index and the American S&P 500 Index have risen sharply from their respective March 2009 lows. Investor psychology has changed drastically. Appetite for risk is back. For example, in recent months, riskier stocks with weak fundamentals have generally outperformed more stable companies. My challenge as your portfolio manager in all environments is to seek satisfactory returns but also to keep Mr. Buffett's lesson in mind. Sometimes that means taking profits when stock prices have advanced ahead of company fundamentals. At all times that means monitoring the levels of risk in the equity portfolios I manage.

<u>Total Return Model Portfolio Update</u>

Therefore, although there are signs of a weak economic recovery, I am opportunistically taking profits in some of the model portfolio holdings that have risen to the point where they are less compelling from a valuation perspective. I am also implementing, or actively considering, the purchase of select lower risk stocks that have not risen as aggressively. These changes will result in a moderately higher allocation to cash than currently exists in the model portfolio and a moderately lower risk profile. Cash positions are currently 26% will rise to over 35% in the near future. Note that cash positions as a percentage of the portfolio have been declining recently due to appreciation in the stocks held, so a portion of this change is just the process of rebalancing in a disciplined manner.

To illustrate my points, I would like to provide specifics regarding the portfolio changes as well as highlight how well some investments have performed:

(1) In April 2009, I added a position in real estate services company CB Richard Ellis Group. In August, I sold roughly half of that position for a gain of 144%. At the time of acquisition, I recognized that this company's

shares were far below fundamental value. Now, some substantial appreciation is in the rearview mirror and the shares offer a less favorable risk/reward balance.

(2) Even more recently, I have disposed of the model's entire position in energy services company Calfrac Well Services Ltd. I initially added the shares to the model portfolio, in May 2009, on the basis that the market would start anticipating an upturn in the drilling cycle as energy prices recovered. This thesis proved correct, and the shares performed beyond my expectations, as accounts will have realized gains of 83%. I am comfortable to walk away from this investment as some technical indicators are suggesting a negative short term move.

(3) Anglo American PLC was added to the portfolio in April 2009 and was sold in August 2009 for a return of 58.8%. The company continues to do very well and I still follow them closely, but as they are a London UK based company, they let their listing on the US exchanges become non-compliant and as such I decided to liquidate the position. There is nothing wrong with taking profit.

Those are the three positions that were new additions to the Total Return Portfolio in 2009 that have already been sold. There have been many new additions in 2009 that are current holdings and are likely to remain longer term holdings. I will list all new 2009 positions in my 4th quarter newsletter but see below for several highlights:

-TD Bank purchased at $39.10 - current price $65.70

-Great-West Life Co. purchased at $18.85 - current price $25.92

-Rogers Sugar Income Fund purchased at $3.21 – current price $4.29

-Westshore Terminals Income Fund purchased at $10.73 – current price $12.50

On the buy side, I am looking to switch from some of the more volatile (or higher beta) investments into more conservative cash flow driven businesses. Hopefully this process will also increase the overall yield of the portfolio as I continue to seek a more stable total return performance from the portfolio. After such a significant move in the market I consider these changes to be prudent, but I also believe that the vast majority of the portfolio should remain intact, as it is composed of numerous high-quality long-term investments and has performed well in the uncertain environment of the past year. My approach has remained quite consistent, mainly because I have a long-term focus and there are some important long-term investment themes I have developed in previous newsletters that continue to affect fundamentals, regardless of short term market gyrations.

Macro-Economic Update

I have touched upon U.S. economic difficulties on several occasions. The latest is that the country's unemployment rate rose to 9.8%, the highest level since June 1983. Unsurprisingly, the daily spending of individual American consumers in the first half of September has dropped roughly 30% in comparison to a year ago. For an economy largely based on consumer spending, this is a dire figure, and it comes despite recent increases in US household wealth supported by rising stock prices.

Some commentators are now saying that economists are wrong to dismiss unemployment as merely a lagging economic indicator, as high unemployment may persist long enough this time to have a significant adverse effect on the economy going forward. For example, housing activity, which has traditionally helped lead the economy out of recession, may be pressured as unemployment boosts foreclosures.

Returning to Buffet's quote on preservation of capital, I continue to shy away from investments linked to the discretionary spending of the US consumer. There is a real risk that weak spending patterns could persist for years. Instead I am focusing on sectors with more promising fundamentals.

America's public sector finances are also in poor shape. The White House's latest deficit projections are noteworthy - a 2009 fiscal year deficit of US$1.58 trillion and a cumulative 10-year budget deficit of roughly $9 trillion. Even for the world's largest economy, these figures are incomprehensibly high, and they could contribute to systemic risks, as I have discussed in previous editions.

This type of profligate government behavior is supportive of precious metals prices, as it weighs on confidence in paper currency and the current financial leadership. Gold recently broke out to a new all-time high of US$1072.00, in reaction to a weaker US dollar. A short-term retracement is quite possible, but the longer-term fundamentals and technicals of gold and other precious metals are encouraging. I continue to maintain an overweight position in precious metals (20%) and believe that my consistent approach with this sector has been the proper one. I have no immediate plans to reduce the portfolio weighting in precious metals, but I will continue to monitor valuations carefully.

Shifting to the global perspective, I have noted in past editions that China appears to be outperforming the US during this downturn. Now, Australia's central bank has unexpectedly raised its benchmark interest rate and signaled further increases in coming months amid signs that country's economy is strengthening. Given that Australia's key trading partners are in Asia, this could be a further sign that economies in the Asia-Pacific region as a group are currently outperforming the United States.

Since the markets for Canada's key commodities are mainly international markets, these signs of international economic improvement are positive for Canada. The US is still our key trading partner, hence the saying "when the US sneezes, Canada catches a cold." So far during this recession, the US has had the flu and Canada has escaped with a cold. While there is now some risk of complacency about the Canadian economy, it is fair to say we have outperformed relative to the US and it appears this is likely to continue.

Thank You to Clients

While we all get caught up in our day to day routines and business relationships, I would like to take this opportunity to thank all of my clients (long-term and new) for their business and emphasize how dedicated I am to providing them with superior investment management services over the long-term. I would also like to specifically thank those clients who recently provided me with glowing testimonials for use in my marketing materials.

A quick reminder - your referrals are a key source of business. Consider contacting me if you know someone who is dissatisfied with their current investments or who could otherwise benefit from my services. Many people out there could be doing much better, often by simply implementing an investment strategy that is more suitable to their risk tolerance or upgrading the quality of their individual investments.

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