CIBC Wood Gundy

2010 Year in Review

The Total Return Model Portfolio has been invested conservatively throughout 2010, as we are not impressed with the strength or the quality of the global economic recovery. The strength of this recovery is being measured by GDP and other statistics, but measuring the quality of this recovery is more subjective. An ideal recovery would be driven by private sector investment in productive assets. Instead, a large proportion of the statistical recovery has been driven by loose monetary and fiscal policy, such as governments borrowing and spending and central banks printing money.

In the short run this produces some statistical positive effects but in the long term it will likely cause new problems. North American stock markets have risen significantly, and many companies are now selling at valuations that imply strong earnings growth for several years into the future. There could be major downside risk if investors are disappointed by actual results. The Total Return Model Portfolio's performance has benefited from the strong stock market recovery, but it is now becoming more difficult to find new investments at acceptable valuations.

<u>Sovereign Debt – A New Crisis in the Making?</u>

Many governments around the world are borrowing and spending in an effort to encourage economic growth. This is occurring at a rate that is not sustainable. The United States is a good example. At the end of 2010, U.S. government total public debt outstanding was US$14.03 trillion, which has risen approximately 65% from the US$8.45 trillion total at the end of 2006. Interestingly, in March 2006, Barack Obama voted against an increase in the U.S. government debt limit as a Senator, which ultimately passed, stating:

> "The fact that we are here today to debate raising America's debt limit is a sign of leadership failure. It is a sign that the U.S. Government can't pay its own bills. It is a sign that we now depend on ongoing financial assistance from foreign countries to finance our Government's reckless fiscal policies. … Increasing America's debt weakens us domestically and internationally. Leadership means that 'the buck stops here. Instead, Washington is shifting the burden of bad choices today onto the backs of our children and grandchildren. America has a debt problem and a failure of leadership. Americans deserve better."

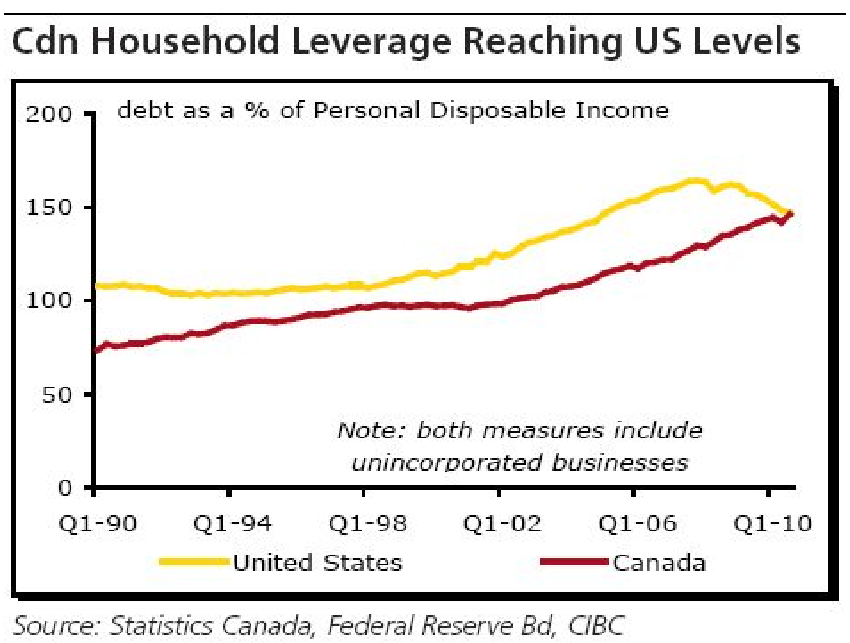
We strongly agree with Obama’s 2006 comments. America had a major debt problem then, and today the problem is 65% worse. In addition, future budget deficits are projected to be massive, so the U.S. national debt will continue to grow. U.S. leaders are clearly unwilling to make the difficult decisions necessary to address this issue.

There are many other countries besides the United States with similar problems, including Japan and European countries like Ireland, Greece, Portugal, Spain, and arguably Belgium and Italy. Canada’s national finances are in reasonably good shape; however, Canadian investments are not immune from financial market turbulence caused by international sovereign debt issues. These issues will weigh on markets for the foreseeable future, as there are no easy solutions.

There are only four ways to deal with excessive sovereign debt – it can be (a) repaid, (b) defaulted on, (c) forgiven, or (d) inflated away. Investors are justifiably concerned that a default scenario would result in deflationary consequences, and attempts to inflate away the debt by creating new money would result in unacceptably high inflation rates.

<u>Household Debt – A Drag on Future Consumption?</u>

The overconsumption and lack of savings of U.S. households contributed to the 2008 financial crisis. However, as shown in the chart below, Canadian households now have a higher debt-to-income ratio than U.S. households. Household debt-to-personal disposable income is now 148.1 percent in comparison to 147.2 percent in the U.S.



Surging amounts of mortgage credit have contributed to these figures. Canadian policy makers realize that excessive household debt is a problem, as demonstrated by Mark Carney's repeated warnings from the Bank of Canada and the federal government's recent move to reduce the maximum term on Canada Mortgage and Housing Corporation (CMHC) insured mortgages from 35 years to 30 years. Unfortunately, these measures could be too little too late for some households.

CMHC itself is an interesting topic. CMHC has insured $773 billion in mortgages and loans, while holding only 1.2% in equity. Before the U.S. government sponsored Fannie Mae went into conservatorship (similar to bankruptcy), it had 1.5% equity in its loan portfolio. We have not made any attempt to assess the risk of CMHC ever requiring a taxpayer bailout in a housing downturn, but some risk could be present. Looking at the big picture of household debt in Canada, we do not think that today's Canadians deserve their reputation of being financially conservative.

Debt-based spending is merely a mechanism that can be used to pull consumption forward in time. It does not create prosperity. A person who lacks the income or savings to buy a new computer today can still buy using debt instead of waiting for savings to accumulate. However, we seem to have forgotten that today's debt-based spending reduces future spending, as the borrower must allocate some future income to debt repayment instead of consumption. Household debt is at elevated levels in North America and is likely to weigh against growth in consumer spending and the overall economy for several years.

<u>Investment Returns</u>

After dropping by 33% in 2008 the TSX Composite Total Return Index rose 30% in 2009 and 14% in 2010. We are not convinced that the underlying economic fundamentals and investment valuations justify current stock prices, so we expect to continue to invest conservatively in 2011.

The Total Return Portfolio has maintained a fluctuating, but significant cash position since July 2007. Longer-term clients will recall perhaps questioning the decision to hold high levels of cash as markets were surging higher into 2008. However, that allocation protected portfolios and led to significant outperformance in 2008. It provided the flexibility to make investments at significantly depressed levels in 2008-2009.

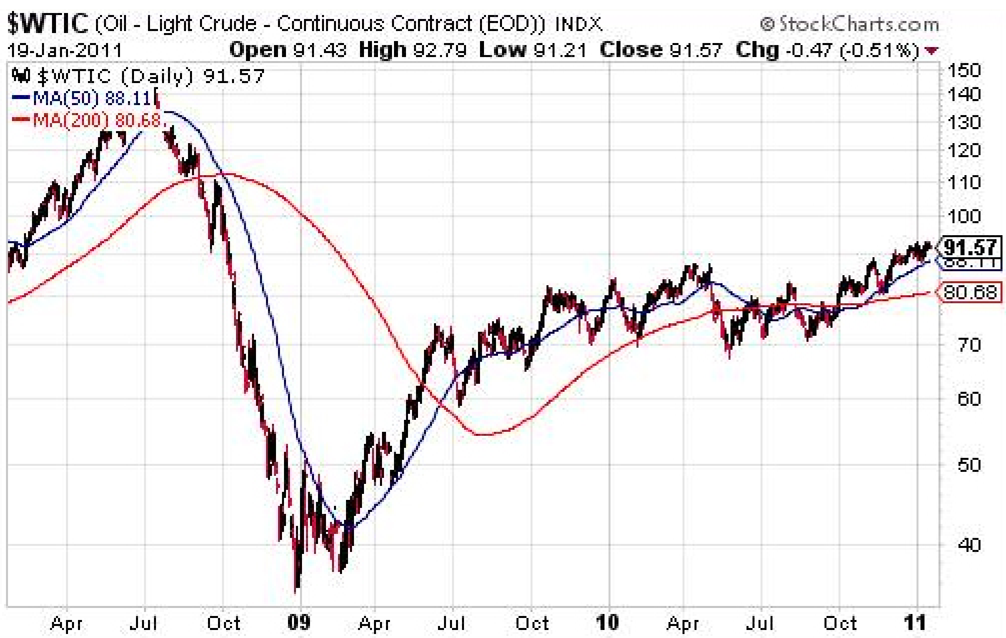
Throughout 2009 and 2010, the Total Return Portfolio has been approximately 65% invested in stocks. Even while taking this conservative approach, we have achieved very positive returns of 27.3% in 2009 and 11.4% in 2010.

Energy

Energy is the largest sector allocation in the Total Return Portfolio. We believe that the fundamentals are generally positive for this sector. Oil is a global market and economic growth in developing economies will contribute to increased global oil demand. For example, the International Energy Agency (IEA) recently raised its global crude-oil demand forecast by 260,000 barrels a day to 88.8 million barrels a day in 2011. Oil producers will be challenged to meet this increased demand.

The oil price is also supported by loose monetary policy around the world to the extent that it results in inflation and currency devaluation. We would not be surprised to see oil trade through the US$100 per barrel level in 2011. Even though we are bullish on oil, we acknowledge that if the price rises too quickly, it can act as a tax on the economy and reduce economic growth. When oil hit US$145 in 2008, it was one of several factors that caused the economy to go into recession.

The chart below illustrates the price action in light crude oil over the past three years:



Our Energy positions include exposure to three companies with investments in Alberta's oil sands: Cenovus Energy, Canadian Oil Sands Trust and Canadian Natural Resources Limited. These companies have the resources in place to grow their production in the medium to long-term, whereas most companies will struggle to find the reserves necessary to grow.

Precious Metals

Precious metals performed exceptionally well in 2010. Silver ended at a 30-year high of US$30.92 per ounce for a return of 83% while gold closed at US$1421 per ounce for a return of 30%. Our silver holdings, Silver Wheaton and Pan American Silver, turned in impressive performances, while our gold stocks lagged our expectations. We are content to maintain our current holdings despite the large price increases, as we took profits on some positions during the year, and we believe the bull market in precious metals has still not reached its final peak. That said, we are anticipating periodic corrections in the sector in 2011, so we expect volatility.

Financials

In the financial sector we hold a pair of solid Canadian insurers and a pair of US banks. The US financial sector has been punished in recent years, and in many cases, deservedly so. However, we purchased a position in Synovus Financial as a risky, but potentially high-reward turnaround play. In our second foray into US financials we bought a much safer company, the Bank of New York Mellon. BNY Mellon is a $39 billion dollar global financial services company that helps clients manage and move their financial assets. It operates in 37 countries, providing asset management, wealth management, and issuer services to institutions, corporations, and high-net-worth individuals. BNY Mellon does not do ordinary retail banking. We believe the shares have attractive appreciation potential, as we bought them at a lower valuation than their historical average.

Our holding in Uranium Participation Corp. is also technically classified as a financial sector investment. Uranium Participation is a Canadian investment fund that was created to invest its assets in uranium, with the objective of achieving appreciation in the value of its uranium holdings. In other words, we made a direct bet on uranium prices increasing. New uranium-consuming nuclear reactors are being built around the world, and especially in Asia. Some old sources of uranium supply, such as decommissioned nuclear warheads, are depleting, which could place pressures on supply.

Other Sectors

We also continue to maintain smaller positions in sectors such as utilities, consumer staples, health care and consumer discretionary, and we have discussed the specifics of these holdings in past editions.

Conclusion

We think that many stock prices have run ahead of economic fundamentals, and that good value is becoming more difficult to find. Individual security selection and tactical trading are going to be the key factors in determining investment returns over the next year. A central bank policy of printing money to stimulate the economy may provide some short-term positive effects, but is not a viable long-term policy. We are investing client assets to profit from selected opportunities in the market while still maintaining a significant cash position to mitigate risk should another market downturn occur.

We wish everyone a great 2011!

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