

## ***Bail-Out or Not, There is Opportunity for Long-Term Investors***

Investor confidence, which has already been reeling from the past year of volatile capital markets, has been shaken to its core over the last couple of weeks as the economic challenges have taken their toll on Wall Street. In addition to unprecedented market volatility, major investment, insurance and banking firms have filed for bankruptcy, been acquired or required government takeover and funding. This week the US government passed a \$700 billion bail-out package aimed at providing much-needed liquidity to the financial system, which essentially could help stem the precipitous slide in values of mortgage-backed securities and financial sector stocks. During times like these, investors may panic and rush to eliminate their market exposure. This is unfortunate because **successful investors look at this kind of volatility as an opportunity to acquire quality assets at discounted prices.** Our investment strategy is focused on maintaining a disciplined approach during good times and bad. It is this strategy that positions our clients to take advantage of the upheaval and realize the benefits as economic conditions improve.

With the bail-out plan in place, the principal positive effect would be the addition of a large and deep pocketed buyer in the markets for illiquid mortgage-backed securities, which have had virtually no takers over the past year. Still many questions remain, making it difficult to predict the positive impact, if any; that the plan would have on the credit markets and broader economy. We face the usual difficulties in predicting the supply and demand of capital.

What is clear is that no government rescue plan will fix the root causes of what appears to be a looming US recession, which will take more time to resolve. Even with government intervention, consumers still lack the spending capacity to support a healthy economy, as every major source of capital they rely on is contracting relative to inflation, including wages, jobs, wealth and profits. Given consumer debt that is still near historic highs, falling house values and a financial crisis that is raising costs and strangling the credit supply, it is unlikely that consumer borrowing would increase. In fact, US consumers appear ready to cut their spending to an extent not seen in 17 yrs of growing consumption, the effect of which would be even more pressure on corporate profits around the world. Current government initiatives are aimed at systemic risks to the financial sector rather than stimulating consumer demand. While the government bail-out plan could help to slow the de-leveraging process (ridding balance sheets of bad debts), it would not be able to stop or reverse it by itself. The biggest potential downside of the plan may be the enormous increase in the supply of Treasury securities, which could increase pressure on funding costs by crowding out other borrowers.

The likely contraction in consumption has yet to be fully reflected in business spending, which typically responds to consumption with a lag. The primary sources of spending strength for businesses in recent quarters—a strong global economy and a falling dollar—are fading.

***The U.S. credit crisis has caused unprecedented levels of market volatility and investor concern.***

The impact of the events in the financial markets has been hard felt within the global equity markets and the global fixed income markets. As the credit crisis has increased in scope and intensity over the past few weeks, the short-term focus of the markets has reached an extreme level. Investors have been willing to forego any investment gain in exchange for capital preservation, driving the yield on the US 3-Month T-Bill to as low as 0.02% as they piled into the safest of short-term government debt. **This short-term focus has also led to the extreme volatility in the markets, both day-to-day and even intraday. This volatility appears to be primarily driven by fear rather than based on fundamentals, leading to frequent and seemingly irrational trading.** The rapid changes in sector leadership among US large companies (as measured by the Russell 1000 Index) are a great illustration of the recent influence investor behaviour has been having on the markets (see Table 1 below).

Table 1

<u>GICS SECTOR GROUPING</u>	<u>Total Return (YTD as of 6/30/08)</u>	<u>GICS SECTOR GROUPING</u>	<u>Total Return (YTD as of 9/19/08)</u>
Energy	11.19	Consumer Staples	-1.62
Materials	2.76	Health Care	-8.51
Utilities	-2.44	Materials	-8.75
Consumer Staples	-7.84	Consumer Discretionary	-9.65
Health Care	-11.84	Energy	-10.12
Information Technology	-12.22	Industrials	-14.71
Industrials	-12.84	Utilities	-16.20
Consumer Discretionary	-15.16	Financials	-17.54
Telecommunication Services	-16.65	Information Technology	-18.11
Financials	-28.02	Telecommunication Services	-23.22

Source: FactSet

**The short-sightedness of reacting to the latest news can cause extreme dislocations between the price of an asset and its true long-term intrinsic value.** This can be a tough environment for active managers who look to invest over the long run. But it can also offer a significant opportunity to capture the upside that should arise as markets eventually recover.

***Navigating Volatile Markets:***

**It is important to note that making drastic changes to an investment program in the midst of a market crisis rarely results in a positive outcome.** While we continue to monitor and make minor adjustments, we are not deviating from our investment philosophy and approach, which has been tested over time and will, in our view, be rewarded in the future. In addition to the asset-class diversification we aim to achieve at the strategy level, we also look to diversify risk across investment styles, investment managers and economic sectors. This level of diversification is intended to result in no single investment having an excessive impact on the overall strategy.

Over time, **clients have been well served by diversification**, benefiting from the long-term returns in equities and fixed income, while mitigating risks. Right now the more conservative strategies are performing better than the more aggressive strategies, which is to be expected in this type of market environment. Still, the last year has been a difficult one for active managers in both equities and fixed income, with the majority of managers in the peer groups having year-to-date returns that have fallen below the market benchmark returns. Because our approach relies on the performance of active managers in different segments of the market, client strategies made up of a mixture of managers have fallen below their benchmarks as well. In particular, managers who follow a value discipline have held onto positions that have declined due to broad-based selling. **They believe that the decline in price does not reflect the fundamental value of their holdings.**

While there have been managers who have performed well in this environment, they have been in the minority. In fact, the managers who are performing well today have had to endure periods in the past where their investment styles were not rewarded by the market. In an environment like this, it is tempting to single out a particular exposure or segment of the market as the primary cause of the underperformance. Being highly diversified, we have some exposure to some of the troubled financial stocks and bonds. However, by themselves these exposures had very little impact on our results since their weight within the Funds and at a broader strategy level is relatively small. **This is the benefit of having a well diversified portfolio.**

While the indiscriminate nature of the selling and the short-term focus of the market has had a negative impact on performance over the last year, we believe that it presents great opportunities for active managers who have a medium-to-long-term view. One area of opportunity is the financial sector, particularly as it becomes clearer which banks and other financial services firms will survive the financial crisis with a greater market share and better competitive position. We'll continue to select fund managers that will look for these opportunities both in the equity and fixed income markets.

In some funds, there is overweight exposure to cyclically sensitive areas such as industrials, materials, energy and consumer discretionary sectors. These have been beaten down by recession fears to the point that the managers believe they are under priced, even discounting their future earnings in expectation of a recession. On the other hand, the managers are avoiding traditionally defensive areas such as health care, utilities and consumer staples, as these stocks have become very expensive despite the likelihood that their earnings will also decline.

Like financial companies, not every mortgage-backed bond has issues with its underlying collateral. Many funds will continue to be positioned in higher-quality sectors that should benefit when yields come off their highs (which is good for investors because yields move inversely to prices), while also being protected on the downside by good credit quality. And as with defensive equities, it is getting very expensive to invest in the safety of government bonds, with Treasury yields currently well below the rate of inflation and continuing to fall.

For fixed income as well as equity securities, all things financial are taking a beating. Yet there will be continued and significant consolidation in the financial services industry, which could be generally favourable for the credit quality of the sector as it will help bolster the capital bases and funding options for the surviving firms.

While some of the positioning mentioned above has caused underperformance as the credit crisis has intensified, and may continue to do so, **we believe these are good long-term opportunities.** While allocation to distressed financial companies varied across client investment strategies, because of our diversification, these exposures did not significantly affect performance (in terms of total return or returns relative to benchmarks).

In the face of a looming recession, it might seem logical to sell assets with any perceived risk and put your money in the safest place. **But history shows that markets tend to recover before economies do (though of course past performance is no guarantee of future performance), and recessions can actually be a fruitful time to invest. In addition when markets move, they tend to move rapidly and many opportunities are missed by those out of the market.**

Our investment strategies are based on the principles of strategic asset allocation rather than tactical asset allocation. They are based on the principles of diversification, not concentration, and they are long-term in nature and therefore are not reactive to short-term themes. These principles have served our clients well over time and we believe that our diversified approach will continue to serve well in the future.