

GLUSKIN SHEFF MARKET OVERVIEW & PORTFOLIO COMMENTARY

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MARKET COMMENTARY

As we enter 2010 we find that most economic forecasts are strongly aligned with each other. The consensus view can be summarized into a few main points: a muted economic recovery but positive growth and no risk of a “double-dip” recession; positive equity market performance for the year and a certainty that volatility will not impede the market’s performance; and a Fed that will begin to tighten monetary policy in the second half of the year, but which will have no impact since interest rates will still be low. As Bob Farrell’s Market Rules to Remember reminds us, when all the experts and forecasts agree, something else is going to happen. In our opinion, the problem with the consensus view is that it assesses the economic events of the last two years as a classic recession/recovery phase; however, in our view, those only exist in the context of secular credit expansions. In our opinion, we are in a post-bubble credit collapse, and it is ongoing.

Mainstream economists called this downturn “The Great Recession”. This is just a gentle way of saying “Depression”. When we come to grips with the fact that we did in fact experience a depression of sorts, then and only then can we conclude that a sustainable recovery will not get underway until the ratio of household credit to personal disposable income in the U.S. reverts to the mean (and goes to an excess in the opposite direction). We know it sounds harsh, but we shall endure. But transition is rarely without pain.

Since 1989, the Japanese stock market saw four 50%-plus rallies, but there has been no period of growth that can be called a sustained expansion. Today, we have our own special set of conditions and it is bound to be tricky as is typical during a post-bubble credit collapse, no matter how intense the government reaction. We believe that the dominant focus in 2010 will be on capital preservation, income orientation and a consistent focus on reliable dividend growth and yield. The range of outcomes in the financial markets and the economy remains extremely wide. One conclusion we can agree on is the need to maintain defensive strategies, minimize volatility and downside risks, and focus on where the secular fundamentals are positive, such as in fixed-income and equity sectors that lever off the commodity sector.

EQUITY STRATEGY

North American equity markets continued to grind higher during the last quarter of 2009: the S&P/TSX Total Return Index and the S&P 500 Total Return Index (CAD) each gained roughly 4% over the quarter. Over the year, however, the Canadian equity market significantly outperformed the broad U.S. equity market, particularly on a currency adjusted basis, as the Canadian dollar appreciated around 16% during 2009. For the full year, the S&P/TSX gained 35.1%, while the S&P 500 gained 26.5% in U.S. dollars and 9.1% in Canadian dollars. In spite of its significant outperformance in 2009, we still favour the superior fundamentals of most Canadian equities, as well as the Canadian dollar over that of the U.S.

In keeping with our cautious stance on equities, we are advocating relatively defensive asset mixes across asset classes. Within many of our equity portfolios, we hold cash balances that are at or above our historic averages. While these cash balances are generally lower than at the end of third quarter, we did take advantage of the general market pullback in October to add to some existing positions and to initiate new

ones. Our portfolios retain significant exposure to commodity-oriented companies, as we feel that the secular bull market in commodities will continue for a number of years. We also remain focused on current income and continue to own many equities and income trusts with attractive dividend and distribution yields.

FIXED INCOME AND CREDIT ALTERNATIVE STRATEGY

Although recent economic data releases have been slightly encouraging and there are some signs that the economy might be in recovery later in 2010, the Bank of Canada has reiterated its intention to keep interest rates low. We do not disagree with policy makers intentions, but we do believe that the market will become concerned that interest rates need to be higher. It is likely that interest rates will start drifting higher around the second quarter of 2010. To be defensive we feel some degree of pre-emptive positioning in our portfolios is prudent.

2009 produced unprecedented returns for credit securities. Our bond portfolios are primarily invested in corporate bonds and we benefited materially from what may be regarded as one of the greatest opportunities in credit ever. We expect that 2010 will be a positive year for credit, but the returns will be more modest – a function of coupon-based return, rather than extraordinary capital appreciation from dramatic interest rate spread compression. This year will be more about specific corporate credit selection, rather than the credit trade, with a vigilant focus on market risk.

To position our portfolios more conservatively we have raised cash by crystallizing gains on numerous securities that have rich valuations. The duration of all of our bond portfolios has been shortened, with the majority of maturities between 1 and 4.5 years. The approaching disappearance of income trusts and the reluctance of banks to aggressively lend to corporations will produce an interesting array of issuers coming to market in 2010, particularly at the beginning of the year. Changing demographics, reduced risk appetite and the desire for income-producing assets should perpetuate the demand for bonds.