GLUSKIN SHEFF MARKET OVERVIEW & PORTFOLIO COMMENTARY

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MARKET COMMENTARY

In the aftermath of the recent G20 meeting, industrial world leaders were focused on fiscal stabilization, responding to the growing investor anxiety over bloated public balance sheets. This is in contrast to a year ago when it was all about rampant fiscal stimulus to bolster the global economy. This cannot be constructive for risk assets, which owed last year's rally to the efforts by governments across the planet to sacrifice their balance sheets at the expense of the private sector.

We believe that escalating global economic imbalances have dramatically increased the vulnerability of the global recovery. Even the once red-hot Canadian economy is showing visible signs of cooling off, and Bank of Canada Governor Carney is now strongly hinting that the rising interest rate cycle he recently embarked on could be truncated.

Whatever pace of economic activity we see, it will likely be insufficient to absorb the still-large amount of excess capacity in the system. The U.S. unemployment rate will stay near double-digit terrain for as far as the eye can see, and Canada's jobless rate will likely remain close to 8%. Inflation and interest rates will accordingly likely remain low for a sustained period of time. A stock market priced for peak earnings in 2011 could be in for some disappointment.

Against this backdrop, our themes of adopting investment strategies that minimize volatility, preserve capital, generate income and maintain exposure to precious metals, given their inherent hedge against ongoing investor concerns over the integrity of the global monetary system, remain appropriate.

EQUITY STRATEGIES

North American equity markets were very volatile during the second quarter of 2010, hitting highs for the year early in the quarter followed by sharp declines over the balance of the period. Over the quarter, the S&P/TSX Total Return Index declined by 5.5% and the S&P 500 Total Return Index declined by 11.4% in U.S. dollars and 7.2% in Canadian dollars. The Canadian dollar fell by 4.6% to US$0.9393, after briefly touching parity early in the quarter. We continue to favour the superior fundamentals of most Canadian equities over those of the U.S., but with our defensive view, we reduced our exposure to both markets over the course of the quarter.

We continue to advocate balanced and relatively defensive asset mixes across asset classes and thus, lower than normal exposure to equities, given our growing concerns regarding global macroeconomic risks. Therefore, within our "barbell approach" to portfolio construction, we are more focused on capital preservation in the near-term, balancing high quality cyclical stocks with defensive, dividend-paying stocks and cash. We have been gradually increasing the defensive tilt of our portfolios by reducing our cyclical holdings in favour of higher tactical cash levels. Although we believe our portfolio companies are well-positioned, we learned from 2008 and early 2009 that financial markets can overshoot both to the upside and to the downside. Therefore, having a higher tactical cash balance affords us the flexibility to preserve capital in the short-term and to go bargain hunting at the opportune time when the risk-reward profile is more compelling.

ALTERNATIVE INVESTMENT STRATEGIES

Our alternative multi-strategy funds remain defensively positioned with low net exposures to the equity markets. We continue to emphasize high quality businesses trading at attractive valuations and paying sizeable and growing dividends. During the quarter, our investments in these international blue chip businesses were negatively impacted by the rapid depreciation of the Euro. Although fundamentals remain strong and valuations compelling, investors grew fearful of the deteriorating European economies. During the quarter, many of our short positions depreciated significantly, helping the performance of our alternative multi-strategy portfolios. Some industrial equities did continue to outperform other cyclical industries, but we believe that this is a short-term phenomenon caused by a belief that the U.S. economy will be relatively unharmed by current global economic events. We continue to be short these economically sensitive industrials where expectations and valuations are extremely high. As always, risk management remains paramount as we monitor these short positions closely.

FIXED INCOME AND CREDIT ALTERNATIVE STRATEGIES

Sovereign risk, waning fiscal stimulus and deficit reduction are providing a fairly negative bias to the markets. When words like "restructuring" or "default" are used in conjunction with what was thought to be safe and secure government debt, it negatively highlights the proviso of obligation to pay. Flight to quality and risk reduction have decreased the price of corporate bonds and widened credit spreads across all sectors of fixed income. For example, bank deposit notes were at 75 bps (¾ of 1%) over governments; they are now at 100 bps, or 33% higher. Government bond yields are approaching historic lows. As we own many bank bonds in our portfolios, this spread widening has a pronounced impact on the shorter-term mark-to-market (MTM) and current returns of our credit portfolios. Our issuers have excellent balance sheets and we continue to expect to receive our contracted periodic interest payments and a return to par value as these bonds get closer to maturity.

We have refrained from making drastic changes in our portfolios. We continue to seek opportunities to replace existing positions with corporate bonds of like quality and higher yields. We are endeavouring to raise the weighted spread of the portfolios to enhance both income and capital appreciation. We recently purchased the debt of Royal Bank of Canada and Bank of Nova Scotia at attractive yields. The recent market disruption has created an opportunity to enhance our portfolios without adding leverage or reducing credit quality. Unfortunately, wider credit spreads produce a temporary negative MTM because we are buying similar higher yielding (lower priced) securities and also marking down the prices of our existing positions.

By adding higher yielding securities to our portfolios, we expect to generate higher income, which over time will mitigate some of the impact of the current negative MTM. The "pull to par" will eventually cause credit spreads to contract and the prices of these bonds to appreciate, generating positive returns and recouping the negative MTM as the bonds mature.