Gluskin Sheff

GLUSKIN SHEFF MARKET OVERVIEW & PORTFOLIO COMMENTARY

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MARKET COMMENTARY

Investor appetite for risk continued unabated during the third quarter as North American equity markets trended higher and corporate spreads on both sides of the border maintained their tightening path to new lows for the year. Financial markets have now gone much further than just pricing out the probability of a financial meltdown, or even pricing out the recession, which was the major story for the second quarter. The most recent leg-up in the equity markets, in particular, has been so pronounced that they are now effectively discounting a V-shaped recovery of around 4% real GDP growth in the U.S. for the coming year. To be sure, it does appear as though governments around the world have managed to install a high level of confidence that a 'double dip' recession is unlikely to occur, but at some point, the rampant fiscal stimulus will fade in terms of its impact, and it will be up to the private sector to sustain the nascent expansion under way. Very strong market technicals and high levels of liquidity may well maintain the bullish investment tone near-term, though at this juncture, there appears to be too much growth and too much risk being embedded in equity valuations.

During the third quarter of 2009, the S&P/TSX Total Return Index rose 11%; the S&P 500 Total Return Index rose 6% (CAD); the NASDAQ Composite Index rose 7% (CAD); crude oil rose by 1% to $70.61 (USD) per barrel; gold rose by 9% to $1,007.70 (USD) per ounce; the Canadian dollar rose 9% to 93.40 cents (USD); and many major emerging equity markets continued to rise at impressive rates.

The overall economic and financial market backdrop is still highly fragile, and the history of post-bubble credit collapses suggests that a healthy degree of caution is still in order. One of the primary effects of the collapse in credit has been a precipitous decline in the value of household assets, notably equities and real estate. Therefore, we can certainly expect consumer and investor behaviour in the future to be radically different than had been the case during the secular bull market in credit and risk assets, a period which encompassed most of our professional lives. The risk is that the investing public becomes increasingly risk averse and that market valuations return to classic levels achieved during previous secular bear markets over the last century. At the same time, it is going to serve us all very well to anticipate where investable assets will be flowing to in coming months and quarters, since 0%-yielding cash will increasingly become less of an option. Though much of the spread compression is now behind us, a modest recovery seems to be better embedded in the pricing of corporate bonds rather than equities. Still, with 'real' inflation-adjusted corporate yields ranging from 6% to 8% in the investment-grade space, the income derived from this asset class is still relatively attractive. So long as there is no setback in Asia from our more cautious view of the U.S. economy, commodities should also continue to be an area of outperformance and result in a sustained uptrend in the Canadian dollar and the Canadian equity market relative to the United States as well as other G7 stock markets.

EQUITY STRATEGY

North American equity markets continued to trend higher over the course of the third quarter of 2009. While recent data points confirm that the healing process for the U.S. economy has begun, we continue

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to believe that the recovery will be more gradual than the current consensus suggests. More relevant to us is the fact that a sharp recovery has already been priced into equity valuations, limiting the potential for positive surprises. We continue to hold cash balances that are above our historic averages in our various models, so that we are able to take advantage of the opportunities to invest in the shares of companies where we think the risk/reward trade-off is favourable.

Our portfolios retain significant exposure to commodity-oriented companies, as we feel that the secular bull market in commodities, driven by supply challenges and demand generated by the superior growth of the large emerging market economies, will continue for a number of years. As a result, we continue to favour the Canadian equity market over the U.S. equity market, in general, given the greater choice of resource companies within the Canadian universe. Our portfolios also have significant exposure to equities and income trusts with attractive current yields, as we feel that dividend and distribution yield will continue to be a very significant part of an investor's total return in the years to come.

ALTERNATIVE INVESTMENT STRATEGY

The GS+A Multi-Strategy Fund and the GS+A Multi-Strategy Opportunities Fund both delivered positive returns with low volatility during the quarter. The funds remain defensively positioned with low net exposures to the equity markets. The majority of the returns year-to-date have been generated from individual security selection.

On the long side, the portfolios continue to emphasize high quality businesses trading at attractive valuations and paying sizeable dividends. Although many of our short positions have appreciated with the market, our long positions have outperformed.

FIXED INCOME AND CREDIT ALTERNATIVE STRATEGY

In an endeavour to keep interest rates low, we believe the U.S. Federal Reserve will continue to buy treasuries, agencies and mortgage backed securities until mid-next year. With no sign of inflation, high unemployment and too much industrial capacity, it is our expectation the Bank of Canada will hold interest rates at current levels through 2010.

While the worst of the credit crisis has been averted and we managed to avoid financial Armageddon, too much optimism is being priced in. The consumer is retrenching, avoiding debt, spending less and saving more. We view the amazing move in equity prices and credit spreads with some degree of trepidation. Although we are very comfortable with the corporate credits we own in our portfolios, we feel corporate credit spreads have moved in far too quickly.

To position the portfolios more conservatively, we have sold a variety of bonds throughout the portfolios and raised cash balances. To be clear, we are not changing our strategy; we are taking some profits, reducing risk and being opportunistic. We still participate in new issues and buy secondary product, but we are selling the less attractive holdings against new purchases. Although we do not see a scenario for spreads to widen materially to anywhere near the extremes of 2008, there is the potential for a modest move wider. We believe year-end dealer balance sheet reduction, increased debt supply and portfolio rebalancing will produce an array of product over the next several months and provide us numerous opportunities to add new credits to the portfolios at valuations we deem more attractive.