coleford

Investment Management

QUARTERLY COMMENT

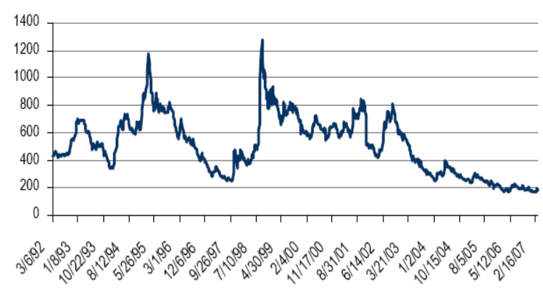
FIRST QUARTER 2007

ECONOMIC ENVIRONMENT

Volatility returned with a vengeance in the first quarter. Fears about a slowdown in Asian growth, growing tensions in the MidEast, the impacts of the unwinding of the yen carry trade and the disarray in the U.S. mortgage market led to large swings in global equity, fixed income and commodity markets.

Investors have been remarkably complacent about risk over the past several quarters.

YIELD SPREADS
EMERGING MARKET/10-YEAR TREASURY



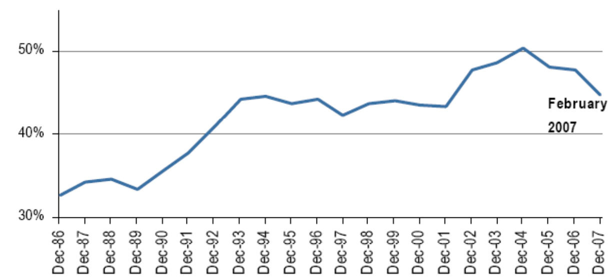
SOURCE: Merrill Lynch Bond Indices

.

Despite threats of mass industry nationalization by Venezuela, the prospect of default by Ecuador, and attempts at capital controls by the Thai government, the additional yield offered for investing in the decidedly risky emerging market debt still hovers near 15-year lows.

Bond investors are not the only ones complacent about risk. There has been a marked increase in the proportion of lower quality companies in the S&P 500 in the past 20 years. Stocks ranked 'B' or lower now account for 45% of the index compared to just over 30% in 1986.

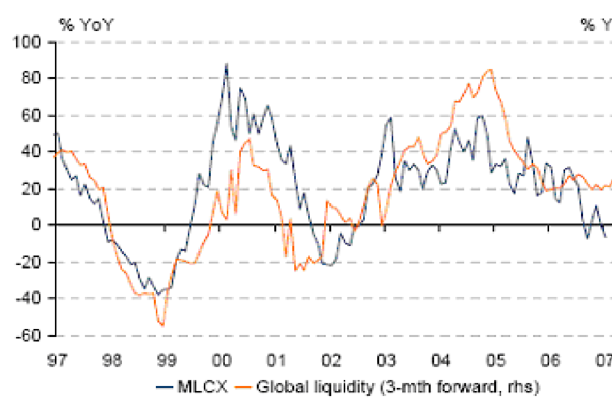
% STOCKS RANKED 'B' OR LOWER



SOURCE: S&P

High levels of global liquidity have been the underpinning to investors sanguine view of the world and part of the impetus behind the commodity price boom of this decade.

GLOBAL LIQUIDITY AND COMMODITIES



SOURCE: Merrill Lynch

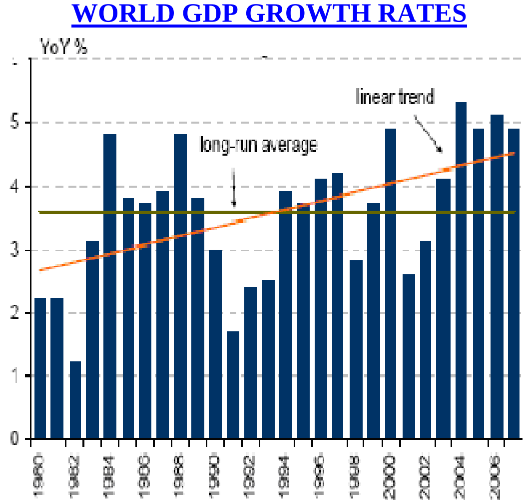
Global liquidity growth has slowed appreciably in the past several months. This slowdown has reduced investors’ appetite for risk.

Nowhere is that more apparent than in the sub-prime mortgage market. Sub-prime mortgages are those issued to borrowers who normally would not qualify for loans or loans with little or no collateral. The slowdown in the housing market coupled with the impact of higher interest rates on adjustable rate mortgages has led to a rapid rise in defaults in the first quarter. The rise has been so large that some sub-prime mortgage companies are now close to bankruptcy.

As we have discussed in previous comments, the buoyant housing market has been a major driver of U.S. economic growth. Consumers were able to use the proceeds from refinancing to maintain spending. The decline in house prices and tightened lending standards will no doubt curtail consumer spending. This is particularly likely as the savings rate is negative and the growth in jobs and real incomes has been anemic in this cycle.

However, it appears unlikely that the U.S. will slip into recession in the near term. Corporate spending has rebounded smartly and global growth is expected to remain well above the long run average.

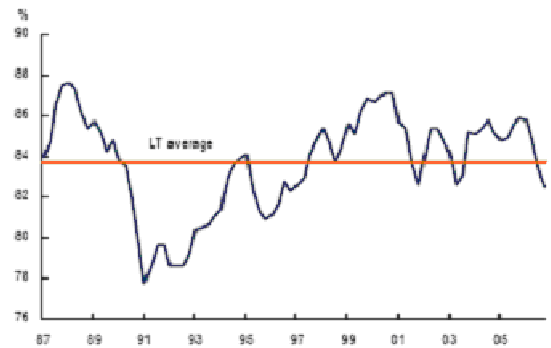
WORLD GDP GROWTH RATES



SOURCE: IMF

The Canadian economy continues to perform below potential. The latest reading of Capacity Utilization, a key indicator of economic health, showed further deterioration to a 10-year low.

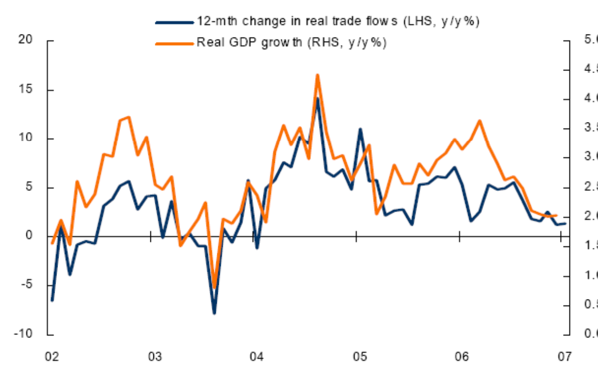
CAPACITY UTILIZATION



SOURCE: Haver Analytics

While export growth remains healthy, import growth has slowed to such an extent that real trade flows are continuing to decline. There is a high correlation between real trade flows and GDP growth, as shown below.

REAL TRADE FLOWS AND GDP GROWTH



SOURCE: Haver Analytics

The latest Federal Budget offered no major stimulus to the overall economy. In fact, some measures like the loss of accelerated depreciation in the oil sands, may actually act as a drag.

As a consequence the Canadian economy is expected to turn in a lackluster performance but, like the U.S. economy, remain out of recession in the near term.

INVESTMENT ENVIRONMENT

The outlook for interest rates in the U.S. was the subject of much debate during the first quarter. While there are clear signs of a decelerating economy, inflation pressures remain persistent and, indeed, intensified. Oil prices rose from $50 a barrel to $66 amid tensions in the MidEast and the whole food commodity complex ramped higher in the quarter. As a result the U.S. Federal Reserve's key inflation gauge, the PCE [personal consumption expenditure index] hovered near a 12- year high.

CORE PCE DEFLATOR
Year-over-year change

SOURCE: Merrill Lynch

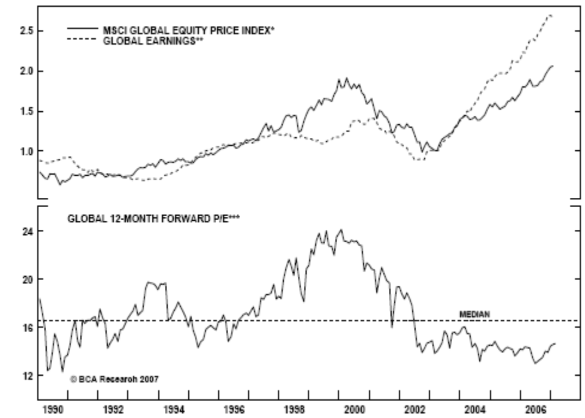
The conflicting forces of rising inflation and slower economic growth are likely to force the Federal Reserve to the sidelines until the economic outlook becomes clearer.

The Canadian Central Bank is in a similar quandary. However, the growth outlook is both somewhat clearer and current conditions somewhat weaker. As a result, interest rates could begin to fall sooner here.

The 10% one-day correction in the Shanghai Index prompted sharp declines in global equity markets. By quarter end though most markets had recovered and approached multi-year, if not, all-time highs.

On the face, global equity markets appear to reasonably valued. Price-earnings multiples, as well as other valuation parameters, are in the mid-range of historical values and certainly well below the excessive levels we saw in 1999 and 2000.

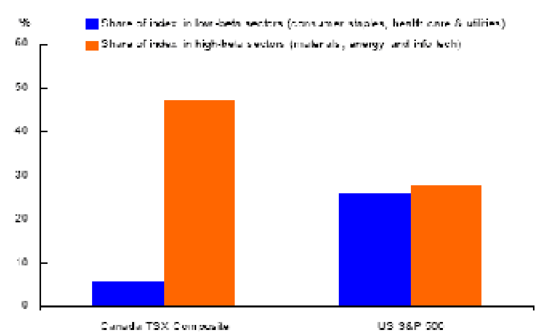
GLOBAL PRICES, PROFITS AND P/Es



SOURCE: BCA

Profitability, on the other hand, is at record levels in both nominal and real terms. The risk is that after five years of growth, profits may stagnate. Should that happen equity markets might, despite reasonable multiples today, be vulnerable.

The risk [or beta] is higher for those equity markets with proportionally more cyclical exposure. The following chart compares that exposure for the TSX and S&P 500.



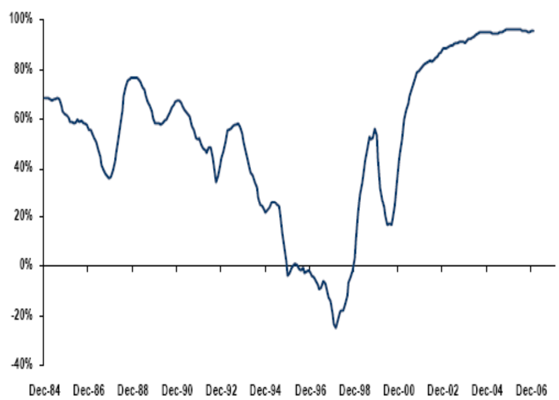
SOURCE: Merrill Lynch

INVESTMENT STRATEGY

The yield curve is still quite flat and spreads between quality tiers are tight. We, therefore, continue to hold bonds towards the shorter end of the maturity spectrum and at the high end of the quality range. We anticipate that 2007 may offer the opportunity to modestly extend term.

One of the little noticed effects of rising globalization is the change in the correlation between global equity markets. The following chart shows the historical correlation between the EAFE Index and the S&P 500.

CORRELATION BETWEEN EAFE AND S&P 500



SOURCE: S&P500

International markets no longer offer the benefits of increased diversification and lower overall volatility.

There are benefits though in participating in the faster growth economies. We have done this in the past by investing in diverse multinationals like 3M, Proctor and Gamble, and IBM. More recently we have added more direct exposure through Aflac.

Aflac is a U.S. specialty heath insurance company that derives 75% of its earnings from Japan. The company has consistently grown earnings at 15% and this pace of growth is expected to continue for the next several years. Growth could be higher if the yen strengthens against the U.S. dollar. Each $.01 move in the yen increases earnings by $.015. The balance sheet is strong and return-on-equity has averaged 23 % over the past five years. Aflac trades at 14.5 times expected 2007 earnings and 12.5 times the level expected in 2008. These multiples are a 12% premium to the peer group. On average, Aflac has traded in a premium range of 10-40%. Aflac is a highly profitable but defensive company with sizeable upside potential over the longer term.

The next few quarters could continue see increased volatility across all markets. Our focus on high quality companies in a wide variety of industries should provide good returns with lower variability.

Todd Edgar William Fillmore Roger Wilson

Laura Wallace Alain Agostini Robert Hill Craig Middaugh Beverley Bucknall