

QUARTERLY COMMENT

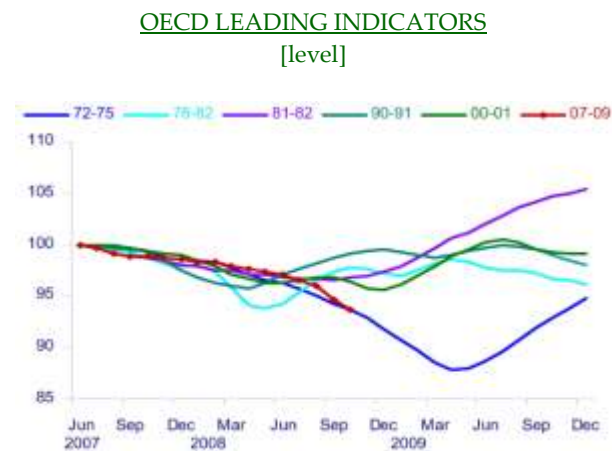
Fourth Quarter 2008

ECONOMIC ENVIRONMENT

The year 2008 saw global equity markets turn in their worst annual performance in decades. For some indices, such as the S&P/TSX and NASDAQ, 2008 was the worst year on record. The decline in equity prices along with the slide in housing prices led to a massive decline in global household net worth. By some estimates \$27 trillion, close to half of the global market capitalization, was lost in 2008.

In contrast to equity markets, government bonds of all maturities staged impressive rallies as investors placed a premium on safety. The demand for safety was so great that the 1-month T-Bill actually traded at a negative yield at several points in the fourth quarter.

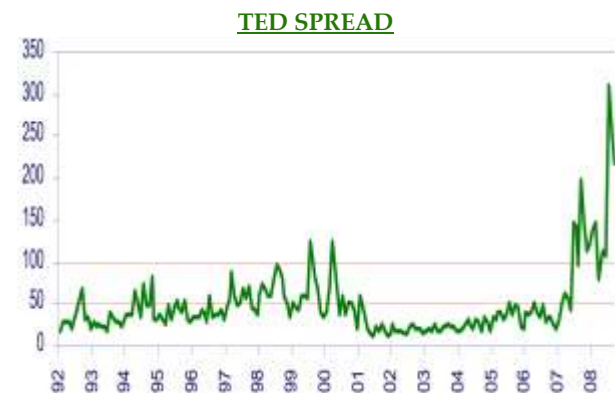
A sharp decline in the level of economic activity has accompanied the stock market decline.



To date, the current recession, as measured by the level of leading indicators is worse than the four previous recessions and is closely mirroring the 1973-1974 experience.

In response to the deteriorating conditions, world governments have launched coordinated monetary and fiscal initiatives. The U.S. Federal Reserve cut the target rate to a range of 0-0.25% and announced several other measures to increase liquidity and spur bank lending activity. In addition to the aid extended to GM and Chrysler, the new U.S. Administration is expected to embark on a massive infrastructure program. Estimates of the size of the program range from \$500-900 billion.

These announcements have restored some confidence in the capital markets.



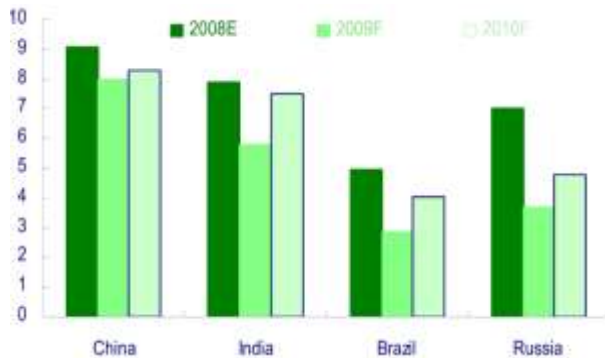
The TED spread [the difference between T-bill and Eurodollar rates] is a commonly used measure of financial strain in global credit markets. It has declined markedly from earlier levels, although it does remain well above the long-term averages. Similarly, corporate bond spreads have narrowed from Depression-era levels while volatility in the stock markets has also retreated sharply. All these are signs that the monetary measures are beginning to have the desired impacts.

The U.S. residential housing market remains one of the keys to an improved outlook. House price stabilization would have a salutary impact on both consumer confidence and financial companies holding investments based on house price valuations.

The U.S. residential market does continue to suffer. Prices for both new and resale houses have declined every month since January 2007. Inventories of unsold homes are at record highs, the pace of sales continues to decelerate and 10% of households are in arrears or default. Despite the continued woes there are some factors suggesting stabilization is closer: affordability indices have steadily improved over the last several months; long-term mortgage rates are at record lows; and there are several proposals on the table to reduce the rate of foreclosure.

Another bright spot is in the developing world. While there is no question that all economies will feel the effects of the events of the last several months, the outlook in emerging economies is brighter.

REAL GDP GROWTH
year/year % change

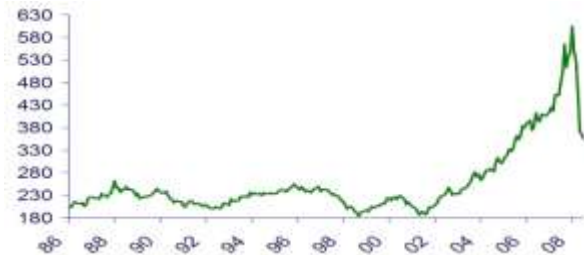


SOURCE: Haver Analytics, Merrill Lynch

The National Bureau of Economic Research has stated that the U.S. entered recession in December 2007. The fourth quarter may prove to be the worst quarter of the recession and if history is a guide, the U.S. economy could be more than two-thirds through the slowdown.

Commodity prices rose dramatically after hitting a multi-year low in 2002. The correction, as the credit crisis expanded, was no less dramatic.

COMMODITY RESEARCH BUREAU INDEX



SOURCE: FACTSET

Despite a 50% correction, prices do remain significantly above the long-run average.

The Canadian dollar has appreciated and fallen in tandem with commodity prices. At the current level, our dollar is in line with the level suggested by purchasing power parity.

The Canadian housing market has declined in 2008 but not nearly to the extent seen in other industrialized markets. Valuation work by Merrill Lynch suggests further declines are likely to be felt most in the Western provinces.

CANADIAN HOUSING MARKET



SOURCE: Merrill Lynch

The Canadian economy is in recession and will undoubtedly weaken in 2009. The extent and duration of the decline will be a function of the U.S. experience, the level of commodity prices and the fiscal and monetary policy response.

INVESTMENT ENVIRONMENT

Over the past year global credit markets experienced strains not seen since the '30's. Although there has been modest improvement in corporate bond spreads, the current level is still indicative of strain in credit markets.

CORPORATE BOND SPREADS



SOURCE: Morgan Stanley

The spread between AA/AAA bonds and Treasury bonds has exceeded levels seen in the midst of the Depression. This unprecedented level of premium is a result of two factors: post-war lows in Government yields as investors sought both safety and liquidity; and, fears that credit ratings did not adequately reflect the risk of default. A more normal spread level will be one of the key indicators of an improved credit environment.

Volatility was the hallmark of equity markets activity in 2008. For example, the S&P 500 had 18 days of 5%+ moves, one more than occurred in the whole period 1956-2007. Although the level of volatility, as measured by the VIX index, did decline by year-end it still remained high in an historical context. Like corporate bond spreads, more average levels of volatility will signal an improved investment climate.

The close to 30%+ declines experienced by both the S&P 500 and S&P/TSX has brought

valuation levels down substantially. For the first time since the mid-fifties, dividend yields on both indices exceed long-term interest rates. Price/earnings ratios, another valuation parameter, have declined precipitously.

PRICE/EARNINGS RATIOS

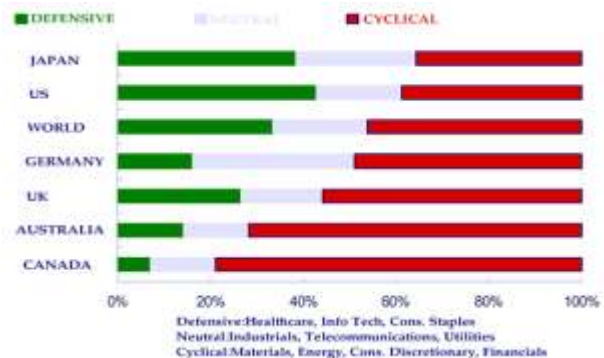


SOURCE: Scotia McLeod

The average P/E ratio since 1956 has averaged 16.0x for the S&P 500 and 17.0x for the S&P/TSX. Current levels for both markets are well below these averages and appear to be discounting a very severe economic outlook. In examining the long-term record of P/E ratios, remember that the seventies and early eighties were periods of high interest rates and rampant inflation. Today, interest rates are at record low levels and the pervasive fear is deflation.

The lower P/E ratio for the Canadian market is probably warranted given its high exposure to cyclical groups.

MARKET COMPOSITION



SOURCE: Merrill Lynch

INVESTMENT STRATEGY

Early in 2008 concerns about inflation dominated economic commentary. Deflation is now the prevailing theme. The implied inflation rates on Real Return Bonds in the U.S. and Canada show how pervasive the deflationary outlook is.

IMPLIED INFLATION PREMIUM 10-year Real Return Bond



SOURCE: Bank of Canada, RBC

Although full extent of the stimulus plans in the U.S. is not currently known, it does seem likely that budget deficits in the U.S., will rise sharply.

U.S. Federal Surplus/Deficit as a % of GDP



SOURCE: RBC Capital Markets

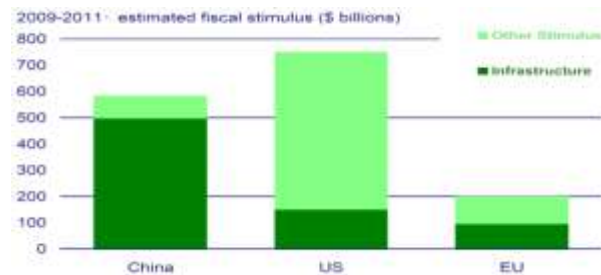
Traditionally, aggressive fiscal and monetary and fiscal policies have been followed by periods of accelerating inflation.

In our view, Real Return Bonds are an ideal way to hedge against the possibility of future

inflation. Because of the accounting complexities, these bonds are only appropriate in non-taxable accounts. Other bond holdings are focused on high quality, shorter term maturities and we continue to evaluate investment grade corporate bonds.

Governments around the world are pursuing infrastructure projects as a means of economic revival.

FISCAL STIMULUS



SOURCE: Government Reports, Morgan Stanley

One of our themes is to invest in companies likely to benefit from this increased infrastructure spend. United Technologies is a global leader in infrastructure development and defense/aerospace through its Carrier, Otis and Sundstrand divisions. More than 60% of its revenues are generated outside North America. The company has an average return on equity of 21% and a debt/capitalization ratio of 30%. Trading at 9.5x expected 2009 earnings and yielding 2.8%, UTX is an attractive investment.

High volatility is expected to persist for some months. Often this type of environment provides the best opportunities to acquire high quality companies at very favourable prices.

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