

QUARTERLY COMMENT
Fourth Quarter 2009

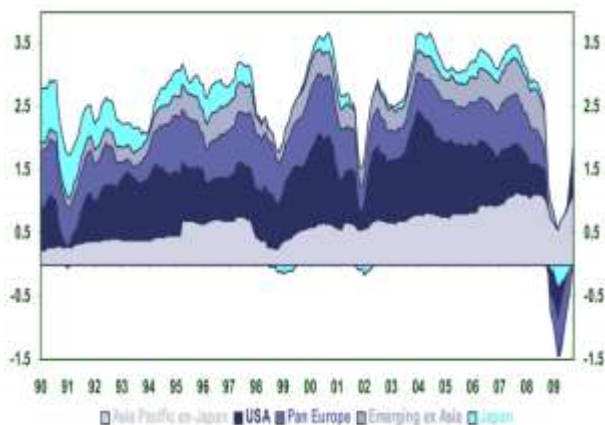
ECONOMIC ENVIRONMENT

Growing optimism about a sustained global economic recovery produced strong returns in world equity markets for the fourth quarter and the year as a whole. As is common in the early stages of a recovery, riskier assets provided the best performances. While the industrialized indices rose sharply, the best returns were recorded in markets like Russia and China where those indices rose 128% and 80%, respectively.

The superior performance of lower quality securities was also apparent in the dispersion of returns within the S&P 500. For example, as detailed by Bespoke Investments, the highest yielding stocks were up 36.5% compared to a 72% increase for stocks with no dividends. Furthermore, the 50 largest stocks in the S&P 500 were up 22% in 2009 while the 50 smallest stocks rose 113%.

The strong performance of emerging market equity indices reflects the contribution those economies are expected to make to global growth.

CONTRIBUTION TO GLOBAL GDP BY REGION



SOURCE: Morgan Stanley

The 2%+ real GDP growth anticipated for the U.S. pales in comparison to the 9% rate expected in China.

Although the improved tone in world capital markets is welcome after the deep consternation evident a year ago, there remain areas of concern.

The credit crisis has receded for most countries, but certainly not all. The well-publicized debt problems of Dubai and Greece are evidence that there is still sovereign debt risk. Indeed, other economies, such as Iceland and Ireland may experience similar issues in 2010. Renewed concern about solvency could have quite negative implications for investor sentiment.

Massive fiscal and monetary stimulus globally has accounted for the bulk of the improvement in economic growth in the past 12 months and has led to low levels of interest rates on both a nominal and real basis.

TEN-YEAR TREASURY YIELD



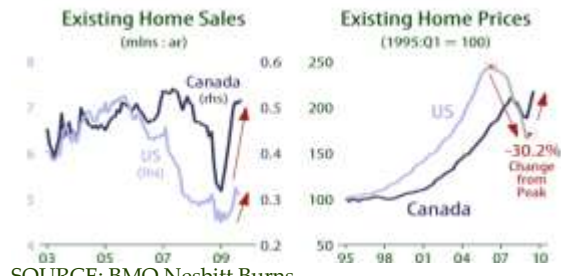
SOURCE: BLS, NBER, DataStream

As government support is curtailed or withdrawn some increase in interest rates seems inevitable. At this juncture, most forecasters expect the increases to occur later in the year and to be relatively modest. Nonetheless, rising interest rates will impact consumer and business confidence and behavior. Of particular concern is the impact on the U.S. consumer who still accounts for 16% of world GDP.

U.S. consumer confidence has been slow to recover and hovers near post-war lows. The lack of substantive recovery can be attributed to two factors: housing and employment.

U.S. residential housing markets improved in 2009.

HOUSING MARKETS



SOURCE: BMO Nesbitt Burns

Unlike Canada though, sales are still lackluster and prices are well below peak levels. As a result, 25% of mortgages are under water and more than 10% of U.S. mortgage loans are in default or arrears.

Worrisome as the housing data is, the more disturbing trends are in the employment statistics.

LONG DURATION UNEMPLOYMENT

[27 weeks or more]



SOURCE: BMO Nesbitt Burns

Long duration or structural unemployment is at record levels in the U.S. Any meaningful recovery in the level of consumer confidence and spending will require much better labour markets. As the Canadian experience has shown, improvement often takes years.

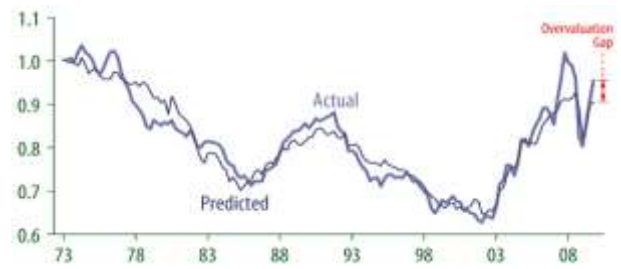
World economic growth should continue to rise in 2010 but the pace may be muted as government stimulus measures are reduced and the U.S. consumer struggles.

Canada's reputation amongst the world's economies rose appreciably in 2009 driven by our strong fiscal and monetary condition and tightly regulated financial sector.

Although the Canadian economy did slide, our exposure to commodities ameliorated the impacts of falling global growth.

Most industrial commodity prices, from aluminum to zinc, did rise strongly in 2009. Predictably, the Canadian dollar staged an impressive rally in U.S. dollar terms. However, as the following chart shows, the level of the Canadian dollar is well above the level predicted by the Bank of Canada's currency model.

CANADIAN DOLLAR AND BOC MODEL



SOURCE: BMO Nesbitt Burns

Gaps between the actual and predicted levels are common but are rarely as large as seen currently.

SPECULATOR POSITIONS IN COMMODITIES



SOURCE: BAS-Merrill Lynch

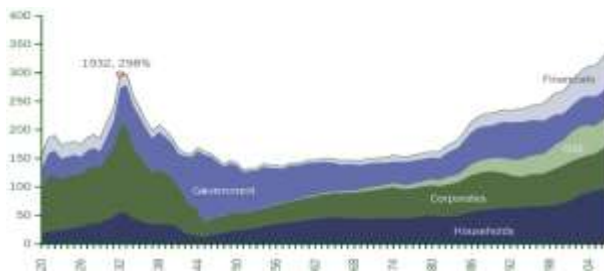
Canada's exposure to emerging economies through our commodity dependence is a long-term positive. In the shorter term though, the rise and fall in the speculative premium in commodity prices can produce substantial volatility.

INVESTMENT ENVIRONMENT

Global credit markets also improved in tone in 2009. The enthusiasm though, was tempered by concern over the massive amount of debt governments assumed as part of the stimulus effort.

The debt concerns are particularly acute in the U.S. where debt as a percentage of GDP has surpassed the levels seen in the 1930's.

U.S. DEBT AS A % OF GDP



SOURCE: Morgan Stanley

Clearly the level of debt is unsustainable and, if history is a guide, the resolution will take several years.

How the debt levels are resolved is the subject of intense debate. Some anticipate a prolonged period of subpar growth, as in Japan, while others expect a return to a high inflation environment.

Near-term, high inflation rates seem unlikely.

CORE INFLATION

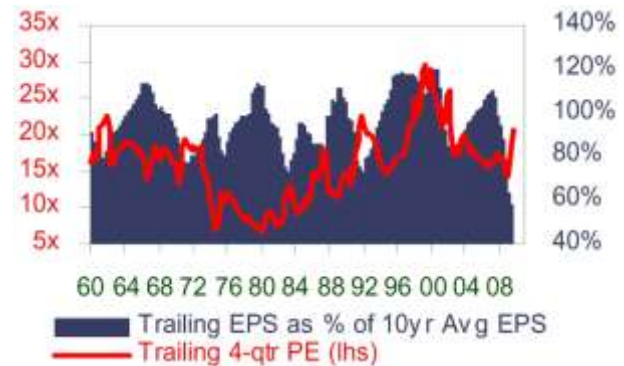


SOURCE: BAS-Merrill Lynch

There is considerable slack in the economy. Capacity utilization is at post-war lows and the unemployment rate is persistently high. In addition, core inflation rates tend to fall for a considerable period following recessions.

No such tempering of enthusiasm is apparent in the equity markets. Despite the fact that the current ratio of earnings to 10-year average earnings is at the lowest level in 50 years, the price-earnings ratio is more than 20x, a 7 year high. An unprecedented recovery in earnings is necessary to justify this multiple.

VALUATION AND EARNINGS



SOURCE: BAS-Merrill Lynch

Earnings did rise in the third quarter and generally exceeded expectations. Most of the earnings improvement was due to aggressive cost cutting rather than rising revenues. Sales growth was actually negative and at one of the worst levels since the 1960's. Despite the lack of revenue growth, analysts are remarkably optimistic. Positive earnings revisions are above average and at close to record levels.

MONTHLY EARNINGS REVISIONS



SOURCE: Sanford Bernstein

Equity markets appear to be discounting a sharp snapback in profitability and appear vulnerable to disappointment.

INVESTMENT STRATEGY

By the close of the year, fear had been replaced by complacency in global capital markets. After reaching record levels at the height of the financial crisis, the TED spread, a common measure of fear, is now below average levels.

TED SPREAD

[3-month Libor-3month Treasury Bill]



SOURCE: Morgan Stanley

While we are certainly more sanguine than a year ago, we remain cognizant of the risks in the global economy. We are employing several strategies to minimize the potential for loss while exploiting the return opportunities.

The evaporation of fear has also been reflected in credit spreads. After reaching Depression-era levels, the risk premiums on lesser quality bonds are near average. Although we never purchase securities with a credit rating below A, we see little incentive to add lower quality bonds.

Inflation does not appear to be a near-term threat. Nonetheless, we hold positions in the Real Return Bond, where appropriate, as a hedge against unexpected rises in inflation.

Although emerging economies are poised to deliver superior performance in the coming

decade, the respective stock indices are generally expensive, highly volatile and poorly regulated.

Owning Canadian stocks is a safer way to participate in that growth as is the purchase of multinationals with substantial operations outside of the developed world. IBM, Toyota, Thomson-Reuters, 3M, Proctor and Gamble and United Technologies are all companies that benefit from these growth opportunities but have the added protections provided by diversification, balance sheet strength and long operating records.

Our philosophy is to invest in high quality companies trading at reasonable valuations. As detailed at the beginning of this piece, those stocks were laggards in 2009. We think now may be an especially opportune time to invest.

Finally, the past decade has been a challenging one for equity investors.

RETURNS: JAN 2000- DEC 2009



SOURCE: BAS-Merrill Lynch

In the U.S. large cap stocks, as represented by the S&P 500, have underperformed every other asset class, from gold to U.S. Treasuries. Our experience tells us that the best return opportunities are often found in the least popular areas.

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