

QUARTERLY COMMENT
Third Quarter 2009

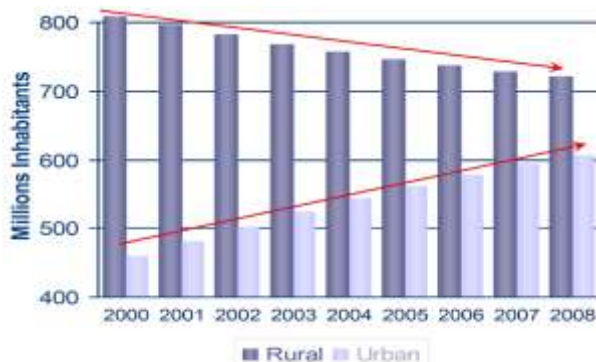
ECONOMIC ENVIRONMENT

Continued improvement in global economic indicators led world equity markets higher in the third quarter. The third quarter rise followed strong second quarter returns. In fact, the two-quarter return for the S&P 500 was the best since 1975 and closely mirrored the experience of the early 1930's. Of course, those two periods were also characterized by severe economic downturns on a global basis.

At quarter end the IMF validated the renewed optimism by raising its forecast for 2010 world GDP growth to 3.1% from its previous forecast of 2.5%. By contrast, world GDP is expected to contract by 1.1% in 2009. While the forecast improvement is significant, the 2010 level is still well below the 5%+ growth rates seen prior to the financial crisis. Additionally, the impetus for growth is expected to come from the emerging economies rather than the industrialized nations.

The rapid pace of industrialization in these economies has led to explosive growth in the urban populations.

URBAN vs. RURAL GROWTH IN CHINA



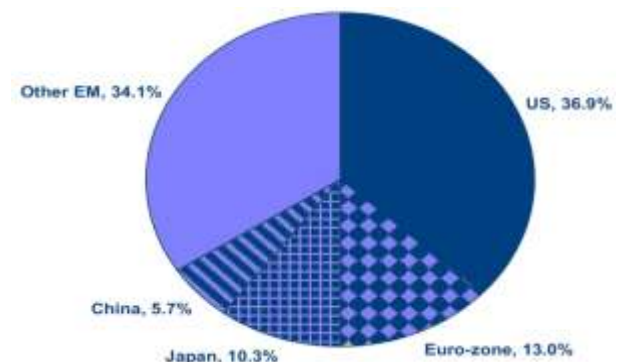
SOURCE: BMO Capital Markets

In turn, rising urbanization has led to greater domestic growth as demand for everything from protein dense foods to consumer products has risen. Nowhere is that more

evident than in China where auto sales recently surpassed those in the U.S.

Despite the rosy outlook for the emerging economies, the global expansion will turn on performance in the industrialized countries and most particularly the performance in the U.S

GLOBAL PRIVATE CONSUMPTION
[% Total in 2008]



SOURCE: Morgan Stanley

The U.S. performance will be driven by the spending actions of the U.S consumer who accounts for close to 70% of U.S. GDP and close to 20% of world GDP. In the wake of the worst economic downturn since the '30's, U.S. consumer spending faces headwinds.

First and perhaps foremost, is the impact the collapse in the residential housing and equity markets has had on the savings habits of individuals. The U.S. savings rate peaked in the early '80's at more than 10% and has been in decline since. There was little incentive to save as household wealth rose steadily through the period. As the next chart shows, even the equity market decline in the early 2000's had little impact on overall wealth. Despite a recent uptick in household wealth, savings rates continue to climb. Paradoxically, while increased savings may be good on an individual basis, rises in overall savings rates

are not good for the economy as a whole.

HOUSEHOLD WEALTH AND SAVINGS RATES



SOURCE: Federal Reserve Board, Hoisington Management

The propensity to save is also likely to increase as the baby boom generation moves into retirement.

The impacts of higher savings rates on consumption can be offset by expansion in the number of employed. This recession, though, has led to the worst employment situation in postwar history. Not only is the unemployment rate not expected to peak before mid-2010, it may exceed the highs seen in the 73-75 recession.

Credit is a necessary ingredient to an economic expansion. The record contraction seen this cycle suggests recovery may be subpar.

BANK CREDIT PLUS COMMERCIAL PAPER 3mos % change, a.r.



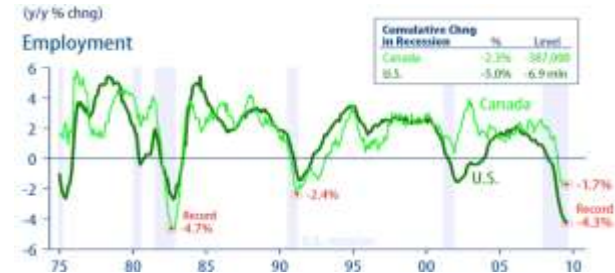
SOURCE: Hoisington Investment Management

The world economy appears to be on the mend but overall growth may be constrained by the lingering effects of the financial crisis on the U.S. economy.

Not only is the Canadian economy expected to exhibit positive growth in 2010, the IMF forecasts that the growth rate of 2.1% will exceed the 1.5% forecast level for the U.S. and be the best in the G-7.

Our better outlook is due, in part; to the fact the recession was less severe here.

U.S. AND CANADIAN EMPLOYMENT

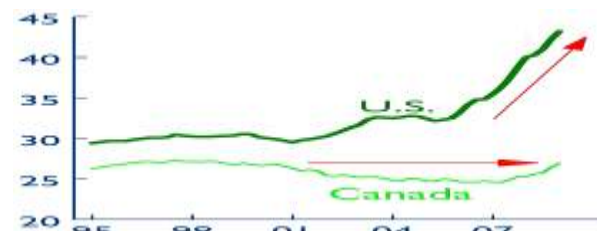


SOURCE: BMO Nesbitt Burns

Using employment levels as a proxy, the current Canadian experience is better than all the downturns since 1975, excluding 2001. The U.S. experience by comparison, is worse than the previous five recessions.

There are many reasons why Canada has had an easier time including the growing importance of the developing world in our economy. However, the differences in the two housing markets explain much of the performance differences. Canadian lending practices are among the most conservative and, as a consequence, the fallout from the housing downturn was far less.

LOAN-TO-HOUSE VALUE



SOURCE: BMO Nesbitt Burns

Nonetheless, the Canadian recovery is expected to lag previous recoveries and, as always, will be dependent on the U.S. pattern.

INVESTMENT ENVIRONMENT

The massive amount of monetary and fiscal stimulus expended by world governments in the past year has raised the spectre of renewed inflation. The concern is especially acute in the U.S. where the size of government deficits and the total amount of debt have exploded.

Conventional wisdom coupled with the recent acceleration of commodity prices suggests increased inflation is imminent. However, the collapse of asset bubbles often unleashes powerful deflationary forces. The most recent example is the Japanese experience of the past two decades.

JAPAN: DEBT AS A % OF GDP



SOURCE: Hoisington Investment Management

The property and equity bubble in Japan burst in 1989 when private and government debt as a percentage of GDP was at historically high levels. Interestingly, the debt percentages continued to rise for several more years. Despite these high levels of debt the Japanese economy has struggled with deflation not inflation. Total debt as a percentage of GDP in the U.S. is 375%, the highest since 1870. Events in the U.S. will not unfold exactly as they did in Japan. It does seem likely, however, that deflationary forces will remain in place for some time.

As noted earlier, equity markets have staged an impressive rally since the lows reached in March. As is common in the early stages of a

rally after meaningful decline, the best performing stocks have been the lowest quality ones.

PERFORMANCE: A+ COMPARED TO C&D



SOURCE: Standard and Poor, BofAML

In the chart above a rising line indicates that high quality stocks [A+] are outperforming low quality stocks [C&D]. A falling line indicates the reverse. The rally of the past six months has erased all the good relative performance shown by the high quality stocks during the financial crisis. The flight to low quality may be premature in light of the challenges facing the U.S. economy and the rapid rise in earnings growth expectations.

The earnings revision ratio is the number of companies whose earnings expectations have been raised divided by the number whose expectations have been lowered. The average ratio is .8 - that is, on average more earnings are revised down than up. The current reading of 1.5 is high and, in the past, been followed by extended periods of disappointment.

EARNINGS REVISION RATIOS



SOURCE: Ned Davis Research

INVESTMENT STRATEGY

Although deflation pressures are evident in the current environment, the low level of interest rates at the long end of the maturity spectrum offers little incentive to extend the average term of bond holdings. We continue to maintain a neutral posture.

Renewed confidence that a depression has been averted has caused spreads between corporate and government bonds to narrow from the high levels seen in recent months. Spreads do though remain well above historic norms. Where appropriate we have initiated positions in investment grade corporate bonds to lock in the superior rates.

Low interest rates have led investors to search for alternative sources of income. High dividend-paying stocks have received increasing attention. This increased focus has come at the same time that the payout ratio [dividends as a percentage of earnings] has climbed to unprecedented levels. High payout ratios are often indicative of a high probability of dividend cuts. A dividend cut leads to a drop in income and, most often, a decline in stock price.

S&P 500 PAYOUT RATIO



SOURCE: Standard and Poor

Dividend paying stocks have always been a key component of our investment strategies. We emphasize not only the level of dividends but, more importantly, the sustainability and likelihood of future dividend increases.

Earlier we noted the outperformance of low quality stocks in the most recent periods. This outperformance has been accompanied by a reversal in valuation parameter trends.

RELATIVE VALUATION BY QUALITY



SOURCE: BofAML

Since the tech boom began in the late 90's, lower quality companies have traded at sizeable premiums. Beginning with the bear market in 2002 that premium began to shrink and indeed evaporated at the height of the financial meltdown. The recent rally has caused the premium to expand once more. Moreover, the best companies are now trading at levels last seen near the height of the 2001 stock market bubble.

In our view, high quality securities are trading at very attractive levels and offer an excellent balance of long-term risk and return potential. Despite the improved tone of capital markets, we are cognizant of the ongoing risks and will remain focused on real and absolute capital preservation.

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