

TURBULENCE IN 2011

With stock markets advancing over 5% in Canada and over 9% in the U.S. during the first quarter of 2011, the year started well. Then, major upheavals on the world stage brought significant instability. These included the tsunami in Japan, the Arab spring leading to the fall of a number of dictators, the debt crisis in Europe and the political paralysis in the U.S. on the issue of raising the debt ceiling. The stage was thus set to create nervousness and volatility in equity markets.

EUROPE ON THE ROAD TO RECOVERY...

After two years of waiting, the Greek crisis peaked this summer when the former Greek president had the "brilliant idea" to submit to a referendum the just concluded long-awaited agreement with the European Union. In addition to helping Greece and Portugal, the majority of European leaders agreed to establish a new fiscal pact and to set up a special fund to support banks, helping to avoid a Lehman Brothers-style meltdown.

We are confident that European leaders, especially the Franco-German tandem, will do everything in their power to contain the debt problems and to preserve the European Union. Let's not forget that Germany has twice received financial assistance since the Second World War (once for post-war reconstruction and later for German reunification). The Germans no doubt have a duty of solidarity towards their European partners. We believe that the efforts begun in 2011 will continue and that a lasting solution

will be implemented. It is long overdue that some nations realize that they are living beyond their means and are practicing seriously flawed fiscal policy. High debt in Europe will not disappear overnight, but the important issue now is to reverse the trend for the benefit of future generations.

THE UNITED STATES, LIGHT AT THE END OF THE TUNNEL...

Against all expectations, while many foresaw a relapse into recession, GDP growth south of the border, though small, was still better than expected with an annualized increase of 1.8% in the third quarter of 2011. The unemployment rate fell from a peak of 10.1% (October 2009) to 8.5% in December 2011, and manufacturing activity continued to grow for a 29th consecutive month. Durable goods orders were up over 9% in 2011. While house prices are still falling, there has been a recent resurgence in real estate as evidenced by sales of new homes, which rose 9.8% year over year. Other indicators, such as retail sales (up 6.7% year over year) and the consumer confidence index (up sharply since October), suggest good news ahead for the U.S. economy.

These economic indicators suggest that the U.S. will avoid a recession and that once again, the doomsday scenarios will not occur. In this election year, we hope that politicians will have the wisdom to put the interests of the nation before partisan interests.

Portfolio managers

REVIEW OF 2011

2011 was frustrating in many ways given that the Canadian stock market experienced a significant decline (see chart) despite the Canadian economy posting annualized GDP growth of 3.4% in the third quarter of 2011. Moreover, the vast majority of companies we hold in our portfolios, roughly 3 out of 4, registered increased earnings during the first 3 quarters of 2011. Despite this, political developments around the world led to equity market declines in Canada in 9 months out of 12.

In this context, we believe it is as relevant – if not more so – to put faith in the fundamentals of companies because sooner or later the pendulum will swing back. In normal times, when reason takes precedence over emotions, a business that generates growing earnings year after year should see its market value grow. As such, the companies we invest in typically have the following profile:

- strong and increasing earnings
- low and declining leverage
- high and rising dividend yields
- repurchase shares

We believe that a very low interest rate environment will favour securities that pay high dividends. We are confident that in the medium term, well-diversified portfolios which are invested in high quality stocks will reward patient investors.

While some investors panic and take refuge in investments offering anemic yields, others are shopping and finding great bargains available. Recently, Germany issued \$4 billion of bonds at a negative yield. Yes, you read that correctly.

Investors are buying bonds that guarantee them losses! This reminds us of the height of the 2008 financial crisis when we witnessed the same phenomenon with U.S. Treasury Bonds (December 2008). In contrast, Warren Buffett,



the legendary "value" investor, invested \$24 billion in the third quarter of 2011, the largest amount for a single quarter in 15 years. Mr. Buffett remains optimistic about the U.S. economy and has repeatedly stated in 2011 that the U.S. economy will not fall into a recession.

In closing, we thank you for the trust you place in us, especially during difficult years like 2011. We assure you that we are putting all our energy and discipline into identifying the very best investment opportunities. We consider risk management in your portfolios of the utmost importance, taking care to invest in profitable companies, which have strong financial positions and are well managed. As always, please contact our managers to further discuss strategy specific to your situation and to confirm whether your asset allocation is still appropriate.

Portfolio managers