

# Winter - 2007

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Dear Clients,

The last 6 months have produced some of the best returns with the least amount of volatility ever recorded. There were only two days between June 30, 2006 and December 29, 2006 during which the U.S. market closed down more than 1%. That hasn't happened since 1945. The raging bull market came on the back of some less than stellar economic statistics: dramatically slowing US housing, record budget deficits, and eroding geopolitical situations (eg. Iraq), to name just three.

Why did this fantasy market happen? The consensus is that the US Federal Reserve has engineered the perfect "soft landing": slower growth ameliorating the threat of inflation, and voila! - much lower interest rates than expected. Remember it's interest rates that have the most dramatic impact on stock markets.

Does the market have it right? Some would suggest that the utopian future as evidenced by the booming stock market is a mirage. The US, and hence North America, is heading for a rough patch. If US rates decline further, the US dollar (already in serious retreat versus the Euro and the Yen) may drop precipitously. Were that to happen, the economies of Europe and Japan would be hard pressed to continue growing their exports to the US. Ergo, a big problem for world growth outside Asia. Should the Chinese decide to diversify their foreign exchange reserves to mitigate the effects of a declining US dollar, we could be in for a major crisis.

The Canadian market is very different. 2006 will go down as the year of the materials or commodity market take-off. Mineral prices have exceeded even the most optimistic forecasts. Asian demand is often given as the reason for record prices of copper, zinc, uranium, etc. It has truly been a bull run second only to the tech bubble of the 1990s. How long can this last, and are the current valuations justified? As long as economic expansion in Asia continues, perhaps. However, any major disruption in the US, Japan, or Europe could put an end to this fairytale as well.

On October 31, the Minister of Finance, Jim Flaherty, announced the income trust tax "holiday" was to be phased out for existing trusts in 2011 and for new trusts in 2007. The Government's intention was to block the conversion of large corporations such as Telus and Bell Canada. They were successful. However, in their haste, they have destroyed one of Canada's unique competitive advantages relative to the US. Using the trust structure, small Canadian companies were able to access the capital markets and create jobs - lots of jobs. Destroying the income trust market to achieve the previous goal was stupid, plain and simple. There were many alternatives that could have accomplished the Government's objective (eg. restricting institutional ownership, increasing non-resident withholding tax, establishing distribution "brackets" with varying tax rates, etc.) without curtailing small companies' vital access to capital.

The consequences for Alberta in particular could be draconian. The oil and gas royalty trusts relied on the trust market to raise funds. The royalty trusts then spent the money drilling wells, installing pipelines, etc. A significant percentage of economic activity in Alberta was directly related to easy access to the trust market. Without that access, coupled with a softening of energy

prices, economic activity in Alberta could slow significantly. Should this occur, the effects will be felt across Canada. Watch for the Canadian dollar to decline with a slowing Canadian economy.

The Bank Credit Analyst (BCA) is one of North America's foremost economic research organizations. They have been around a long time. While they do not see a recession on the horizon, they do see a slowdown in US growth. Historically, the average return in the major equity markets between 1950 and 1995 was 8.6% after adjusting for inflation. Even in the BCA's most optimistic scenario, they forecast only 6.7% annual growth for the next decade. With today's nominal bond yields around 4%, it's hard to see where double digit returns can come from.

Combining the Federal Government's tax decision on income trusts with the BCA's sobering capital market expectations, we have to ask: how do we plan to meet our investment goals? The answer in our opinion is to utilize an investment discipline that performs independently of stock and bond markets. This is accomplished by investing in a broad range of securities which enhance returns, reduce volatility and provide true diversification to an investor's portfolio. As the distinguished academic Dr. Robert Arnott puts it in Volume 62, Number 5 of the **Financial Analysts Journal**:

*"The classic 60/40 balanced portfolio is not true diversification. Indeed, one of the best kept secrets of the investing community is that the stock market return so dominates the risk of a 60/40 strategy that the portfolio exhibits a 98% to 99% correlation with the stocks! True diversification involves seeking uncorrelated or lightly correlated risky markets, not low-risk markets. Finally just as wealth is not solely a function of asset growth, risk is not solely a function of asset volatility."*

We believe that we have the right strategy at the right time. True diversification is not owning 100 or 200 stocks and a few plain vanilla bonds. It may work in a raging bull market, like the one recently seen in Canada, but when you are an opportunistic, deep value manager looking for unique circumstances it can take a strong will to stick to your knitting. Temptation to follow the crowd is always there and it only increases during times when speculation runs rampant. But going forward - in terms of both risk and reward - this approach is simply not going to deliver.

So what should you expect to see from us over the next three months? We are adding an exceptional international equity manager that focuses on identifying undervalued securities in nearly 50 markets outside of North America. Our endless search for skilled management outside our areas of expertise has also uncovered an authentic hedge fund and an astute commodities specialist, both of whom will add greatly to our unique asset management strategy.

More details of these changes will be forthcoming in the next couple of weeks. Look for news from us on our new website: [www.barlowcp.com](http://www.barlowcp.com)

In closing we would like to leave you with this thought. While much about future economic events and market returns is unknown, there is one thing that we are certain of: our investment approach will continue to generate significantly better risk-adjusted returns than the conventional Canadian Balanced Fund.

Sincerely,

**STEPHEN D. BARLOW**

December 29, 2006