

Winter - 2007



Dear Clients,

2007 will go down as the year we all learned everything we forgot about liquidity. The academic definition of liquidity is the ability to sell a security at its fair market value (or intrinsic value) without seriously affecting the price. For the prior 5 years before the second half of 2007, the markets were awash in liquidity. Money was cheap and plentiful. The US sub-prime mortgage collapse changed everything. As we commented previously, the ability of the US investment banks to package this toxic waste and export their dirty laundry around the world is what triggered the current global liquidity crisis.

While we were perhaps a little too smug in the fact that we didn't own any sub-prime paper or any of the US investment banks, we didn't however, foresee how fast the contagion would spread. The global markets are truly interdependent and a crisis in one quickly becomes a crisis in all. The sub-prime contagion hit Canada hard in our non-bank commercial paper market, better known as asset-backed commercial paper (ABCP). The ABCP market has essentially seized up, marooning perhaps \$35 billion in assets. The spill-over to other credit markets in Canada has been dramatic. Anecdotal evidence suggests real estate mezzanine financing rates have moved from ~12% to perhaps ~18%, if you can raise money at all.

The equity market fall-out from the credit crisis is felt especially hard in the small cap arena. Small cap companies in Canada rely on the equity market to raise capital to fund merger and acquisitions, capital expenditures and US expansion. Cut-off their access to capital and their business plans often falter and subsequently, their share prices. With the rare exception of Timminco and a few others it has been a dreadful year for small caps, especially technology and biotech. On the resource side, we had the one/two punch of the 2006 Halloween tax nightmare (killing income trusts) followed by Alberta's decision to raise royalties on gas production in the middle of a collapse in conventional drilling. Both were truly stupid public policy decisions.

How has the credit market upheaval affected the Income and Growth Portfolio? Every move we have made in the past couple of months has been with one eye on liquidity. We don't ever want to be in a position of having to sell something just to raise cash. We haven't added

any new positions we can't liquidate overnight. We have maintained a huge overweight position in cash, which is paying us ~5% versus the 10-year Canada bond yield of ~4%.

The investment themes we articulated in our third quarter commentary haven't changed. We have a lot of exposure to oil (particularly the North Sea off the UK and Thailand) and we continue to pursue high dividend yields from non-cyclical stocks, eg. school buses and infrastructure plays. The only difference in our current strategy is regardless of the attractiveness of small caps at these price levels, we won't commit new money until the liquidity crisis subsides. Survival is Job 1!

Sincerely,

STEPHEN D. BARLOW

December 31, 2007