VERITAS

Fall 2007

In a recent comment, the Conference Board of Canada reported that as measured by having GDP per capita above the national average, Canada has only one "have" province, Alberta, as compared to the 1980s when the list included BC and Ontario. BC has since slipped to roughly 96% of the national average, and Ontario remains just at the average. Ironically, at the time the report was published, Ontario was experiencing the strongest jobs growth in Canada, and in BC, where the labour market remains very tight, striking Vancouver civic workers were being hired off the picket lines by private businesses. With national jobs growth rates rising, labour markets becoming ever tighter and Canadian unemployment at 33 year lows, BC and Ontario may reclaim their lost status. Our dollar recently reached parity with the US dollar for the first time since 1976. Much of the recent appreciation in our dollar has been based on strong Canadian economic fundamentals. However, the most recent spurt has been more in response to the recent cut in US interest rates because of the difficulties experienced in their credit markets. The cut makes our rates more attractive, drawing investors to our market, thereby increasing demand for our dollar to purchase investments here. This may put our dollar's recent gains at risk if our interest rates fall.

Current Situation

In the middle of August, Canadian and US equity markets fell quickly and sharply, stemming from the collapse of the US sub-prime lending market. At one point on August 16th, the TSX traded negative for the year, having declined over 14 percentage points from its record high set only weeks before. Trading in this volatile period saw investors indiscriminately selling good assets along with the bad, accelerating the broad market declines. In part, selling was being driven by margin calls on leveraged trading accounts where the value of the underlying securities was no longer sufficient to satisfy the security for the loan on the account, and by mutual fund managers responding to panicked investors' redemption demands. As the selling pressure subsided, markets recovered, led by strong companies with little or no sub-prime exposure, resulting in a 9.2% year to date gain for the TSX. Although markets are trading at levels lower than before the correction, current gains are still better than historical averages.

Aside from the failure of many of the companies participating in the sub-prime asset backed commercial paper (ABCP) market, a consequence of the tightening credit conditions and August correction is the cancellation of several corporate mergers. Many recently completed deals had been done at historically high prices, with only the extremely low cost of borrowing making them economically viable, which has been artificially inflating asset prices beyond their fundamental values. Higher interest rates are now forcing deal makers to look at the economics of the deals, as opposed to just doing them because they can. It would appear that it was not just retail investors who were taking on excessive levels of risk for the sake of return.

Examining the sub-prime and ABCP market, it is worth noting that it is not just one 'thing', and that the August credit liquidity squeeze was as a result of a combination of a series of factors. Exotic mortgages, such as interest only and high ratio mortgages, have been around for decades, and are not necessarily sub-prime. These loans have been historically provided to people, often small business owners and other entrepreneurs, who, while successful in business, do not qualify for a mainstream loan, but have the financial security to support the debt. Non-traditional lenders would fill the void left by the mainstream lenders, and write an unconventional loan with terms to fit the client, but with higher debt service costs to compensate the lender for the risk and creativity. What makes these and other loans sub-prime is the lack of security and creditworthiness of the borrower. This is where the originators of the non-traditional loans contributed to the recent turmoil by departing from their standard practices and lending to individuals who could never qualify for a normal mortgage, but nor did they possess the qualifications for an exotic. This was made worse by borrowers misrepresenting their financial status and earnings to the lenders, who in turn made no effort to verify the claims. In several documented cases, lenders encouraged the fraud, helping the borrower enter into transactions, the consequences of which they had little understanding. Finally, the investors who purchased the ABCPs, instruments that look like a bond that are used to aggregate a series of loans and their attendant default risk off a lender's books into investors' hands, can be held accountable for creating the increased demand for these instruments in a bid for yield. The problem was that as the increasing demand was being satisfied, the underlying quality of the assets was deteriorating, making what was historically a relatively safe asset very risky, a fact that was being ignored by the market. Until August. The market suddenly started paying much less for the riskier ABCPs, or in some cases stopped buying them altogether, creating a liquidity squeeze and a chain reaction, resulting in an escalation of foreclosures, and the failure of many lesser quality lenders and aggregators. On a reassuring note, this market is much larger in the US than in Canada, but even in the US, it represents a very small percentage of outstanding loans.

OUTLOOK

Our 2008 outlook for Canada is cautiously optimistic. Our economic growth is expected to top 2.8% in 2007, and moderate to 2.5% in 2008. Growth will continue to be dominated by exports, and any softness in exports is expected to be offset by increasing domestic demand for labour and goods. Global economic growth is forecast at approximately 4.4%, the largest contributors being China and India, growing at 11% and 9% respectively. European economic activity is anticipated to grow at a stable 2.5% based on strong industrial production and declining unemployment. The only area of concern for us remains the US, although economic growth there is still forecast at 2.5%. We are uncomfortable with this outlook and expect that it will be revised downwards because of the marked year over year decline in consumer sentiment, deterioration in the credit market and what is turning into a housing recession, all of which argue for slower economic growth. If a US economic contraction does occur, Canada will feel less of an impact than in the past. Since last year, our exports to the US are down over 3%, but up 25% to the rest of the world. Other factors that are contributing to our 2008 optimism include a $13.8 billion federal budget surplus, strong housing and labour markets, low interest rates and controlled inflation, and equity markets trading at valuations lower than the 2002 valuation trough reached after the tech wreck.

STRATEGY

Given the strength in returns that client portfolios have already experienced this year, we will be taking profits and raising cash as we head into the current portfolio review period. Maintaining a more defensive posture, we expect to exit the year with higher than our normal 5—10% cash levels. In addition to some modest profit taking on existing holdings, we will be removing two equity positions from client portfolios before year end. In one case, the company is subject to a takeover bid, and is trading very near its takeout price, limiting any further capital appreciation potential. The second simply has not performed as expected, and in both cases, the capital can be better deployed elsewhere. We have identified replacement names that will complement current holdings as to quality, defensiveness and expected returns stability. While we are in an environment where interest rates remain low, and our strong dollar is acting as an economic brake controlling inflation, our asset mix will continue to favour equities.

Please feel free to call with questions or for further discussion.

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