VERITAS

Summer 2007

In the final chapter of a story we have been following for some time, a deal has been struck whereby Chrysler will be taken over by a private equity firm for the price of its debt. Daimler will receive nothing for the division, and in fact will have to pay US $677 million to the purchaser, but will be able to transfer Chrysler's debt and health care obligations to them as well. Taking all into consideration, the value of the deal is US $7.4 billion, roughly 20% of the original merger value. In another sale story, after seeing a steady deterioration in profitability since selling Tim Horton's, it appears that Wendy's itself is on the block, largely at the prodding of a dissident shareholder. For those who believe in coincidence, the shareholder in question is the same individual that perhaps erroneously campaigned for the sale of Tim's, one of Wendy's most profitable divisions. As an aside, we find it discomforting to know that one individual, even as a significant but minority shareholder, can compel his agenda on a supposedly independent board of directors, often to the detriment of other shareholders, who, more often than not, do not rebuff the dissident. On a lighter and unrelated note, Toyota finally usurped GM as the largest car manufacturer in the world, selling 109,000 more cars than GM last quarter.

CURRENT SITUATION

Canadian markets continue to perform better than expectations, but with the anticipated higher levels of volatility. As at June 30, 2007, the TSX composite total return index, which includes dividends, was up 9.10%, but endured several reversals in getting there. Of note, the TSX declined over five percentage points in the spring as a series of negative international economic headlines took their toll on financial markets. However, as the news, and its implications, was digested, markets rebounded and continued their upward track. Since then, there have been numerous triple digit declines and rebounds, but it should be noted that with markets at current levels of approximately 14,000, a 140-point decline represents only one percent. So, while the absolute point declines and rebounds have been large, contributing to the higher levels of volatility, the overall percentage impact has been less severe.

Turning to the US, for Canadian investors it has been a tale of two markets and two currencies, as has been the case over the last several quarters. US returns, when measured in US dollars, were a relatively healthy 7% to date, but decline to negative 2.3% when converted to Canadian dollars. While there are indications that the US economy remains reasonably healthy, largely still as a function of consumer spending, the question of how long the strength can last is increasingly being asked. It is the uncertainty of the answer to this question along with the continuing deterioration of the US budget and trade positions that is taking a toll on the US dollar. While these structural problems are not new, they are being exacerbated by the concerns arising from the widely publicized consequences arising from the collapse of some of the sub-prime mortgage lenders and the increasing awareness of the potential negative consequences that private equity takeovers are having on the US economy. Add the fact that 2008 is an election year, with no clear front-runner candidates at this time, and the result is a recipe for a weak currency not unlike the Canadian experience of not too many years ago. While the weakness in the US dollar is often lamented because its decline makes imports into the US, which includes travel abroad, much more expensive, its weakness may serve to reduce consumer demand for imported goods, resulting in more domestically focussed spending habits. This, combined with the more attractive pricing of US exports as a result of the weak dollar, could potentially spell the next stage of the revival of the US economy, with the rebuilding of domestic industries that had seen their operations sent overseas. There is no assurance this will happen, and if it does, it will take years to rebuild the

lost capacity, but it is possible.

Overseas, in their ongoing efforts to rein in stock market speculation, the Chinese government has raised interest charges on investment loans, tripled the so-called stamp duty, which is a tax levied on stock trading, and has significantly increased the interest banks are allowed to pay on savings accounts. Yet despite the efforts, and the resulting 6% market pullback in response to the measures, "naïve" money continues to pour into the markets. A record 455,111 retail trading accounts were opened on May 28, capping a two week period in which over 300,000 accounts per day were opened. This was eclipsed in the first two weeks of June, our last data point, during which over 400,000 accounts per day were opened. The previously referred to bubble characteristics of the Chinese market are even more evident today.

OUTLOOK

We have been commenting for some time that the economic environment continues to be supportive of equities. Canada has been running a current account surplus for 31 consecutive quarters and TSX earnings are up 182% since their 2002 trough. Part of that rise is based on rising commodity prices, but much of it comes from improving margins resulting from productivity and efficiency gains. However, good as it is, we feel that the current environment is not strong enough to warrant further consecutive strong double-digit gains in share prices. This position has been reinforced by the Bank of Canada increasing interest rates by a quarter percentage point on July 10, and by seeing overall bond yields steadily moving higher over the last six months. Higher bond yields reduce the relative attractiveness of stocks to bonds by eroding the equity premium. The equity premium is defined as the amount of return expected from stocks in excess of bonds for the additional risk assumed to own the stocks. Further erosion is likely as interest rates in Canada continue to move up modestly in response to more signs of rising inflation. This aside, there is a new factor that has emerged over the last couple of years that is lending non-fundamental support to stock prices, and that is liquidity. There are trillions of dollars coming from emerging export nations that are looking for an investment that provides higher returns than can be earned domestically, resulting in much of this money being invested in stocks abroad, including in Canada. The concern we have is that this money is extremely return-sensitive, and will exit an investment at a moment's notice, making it an inaccurate gauge of the real long-term demand for stocks and the health of stock markets, and adding considerably to volatility. Despite our concerns, we see a combination of benign inflation, healthy and modestly improving corporate profitability and moderately strong global economic growth providing conservative fundamental support to equity markets for the next 12-18 months.

STRATEGY

Based on our outlook for only modestly higher interest rates in the near term, we continue to favour equities as the preferred asset class. Although bonds are becoming somewhat more attractive, the Canadian yield curve is inverted, meaning that the highest returns are being earned on the shorter bonds. Historically, the opposite has been the case, and investors were compensated for taking on time risk by earning higher returns on the longer bonds. And because short bonds generally do not have a capital appreciation component, the yield purchased today is the yield you hold to maturity. Stocks exhibit the opposite characteristics, generally rewarding investors more the longer the stocks are held, which fits with this firm's discipline of maintaining a long-term outlook, and investing our clients' portfolios accordingly. In keeping with our discipline, we continue to avoid momentum plays, and focus on well and conservatively managed companies whose fortunes are not impaired by short term economic or market trends.

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

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