VERITAS

Winter 2009

DID YOU KNOW...

- **V** Japan's population is set to decline by a third over the next 50 years, with working age population declining at an even faster rate.
- **V** Despite predictions of its imminent demise, even prior to its launch, the Euro celebrated its tenth anniversary on January 1, 2009.
- **V** Canadian interest rates are at their lowest levels since 1958, and are forecasted to go lower.
- **V** Total US consumer debt accounts for more than 2.3 times GDP, having grown at twice the rate of the economy since 1981 as consumers confused credit with income.
- **V** For the first time in its history, because of the decline in its manufacturing industry, Ontario is in the unenviable position of being a "have not" province, and qualifies for equalization payments in 2009.
- **V** Compensation historically consumes half or more of every dollar of revenue generated on Wall Street.
- **V** Conditions are so dire for some people in the US that they have been forced to sell their burial plots to make ends meet.

CURRENT SITUATION

The S&P/TSX Total Return Index, which includes dividends, ended one of the most volatile years in its history down 33%, putting us firmly in a bear market for 2008. If we look at 2008 returns from peak to trough, the decline was closer to 50%. On a more positive note, the TSX finished the year 16% higher than the low it hit on November 20th. Commodity related stocks had the largest decline as global demand for virtually every commodity softened, reflecting the decline in economic output arising from the fears of the effects of a global recession. As dire as conditions appear to be, there is evidence to suggest that the recent sell off has been overdone, much as the run-up earlier in 2008 was as well. This condition could lead all markets, from real estate to commodities, to quickly rebound to some equilibrium between current levels and the over inflated levels recently experienced. Any asset will find a buyer at the right price, and there is a tremendous amount of uninvested capital in the system that will need to be put to work looking for those assets.

Market sentiment will have to improve before any kind of recovery can be expected, and there are signs that this is happening. For example, volatility in the equity markets, although still high, is roughly half what it was at its worst. The increased stability reduces the risk of forced selling by investors, principally hedge and mutual funds, to meet redemption and margin call demands, activity that played a major role in recent market declines. The reduction in forced selling provides another degree of market stability, which in turn stems further forced selling. Perhaps more importantly, it also provides some confidence for the retail investor who has to this point been responding to media hype and panic, and selling into the declining market. As these sellers are calmed, markets stabilize even further. Provided there is not another event to shake investor confidence, in the manner that the failure of Lehman Brothers did, market volatility might return to normal levels this year.

There has been much press devoted to the severe decline in the markets and economic activity, and speculation that we are on track for a depression. To put current conditions into historical perspective, using US data, the US officially fell into recession in December 2007, making it now 13 months old. To this point, the longest US recessions have been 16 months, with the average being 10.4. The average of previous recessions saw economic output, corporate profitability and employment fall significantly further than they have in the present downturn. Arguably, this could be taken to mean that the worst is yet to come or alternatively, that what we are experiencing is a tremendous but temporary economic disruption that was brought on by a combination of factors and events, the most influential being the re-evaluation of lending practices. As the process evolves, and credit markets become more liquid, global economic activity should pick up. It is certain that weaker participants, including some governments and countries such as Iceland, which recently went bankrupt, will not survive in their current form. Hopefully they will serve as examples of the consequences of relying on unrealistically optimistic assumptions when formulating corporate and economic policy.

While the downturn may be as severe as the 1930s, this is where the similarities end, and why it is hoped the its outcome will not be a depression. Using US data again, 1930s era unemployment was at 25% versus closer to 6% today. In the 1930s, when banks failed, depositors lost their life savings. Today deposits are insured. Monetary policy response in the 1930s was limited by the gold standard, which no longer exists, allowing for loan and deposit guarantees like those already provided by the Federal Reserve. Stimulus initiatives were delayed or cut altogether in the 1930s, whereas they are front and centre today. Finally, virtually all developed economies are coordinating their responses to the disruption, as opposed to the 1930s when the responses were few, delayed and *ad hoc*.

What has transpired over the past year has been dramatic, and it will be interesting to see how attitudes, policies and governance will change as a result. The impact the disruption has had on prudent investors, who were not speculating or chasing returns without regard to the associated risk, has been very disappointing. We hope these are the investors who are first and best rewarded as we emerge from this downturn.

OUTLOOK

We expect that 2009 will be another challenging year for investors, but that there will be an overall positive bias to the equity markets. The effects of massive global stimulus programs will begin to be felt, interest rates will remain low, and as credit markets begin to function again, of which there are signs even now, economies will start to recover, and business expansion will resume. We anticipate that market participants will return to the practice of purchasing assets with return expectations built on realistic estimates of sustainable economic activity, with an appropriate premium for the risk being assumed. As investors' appetite for risk returns, money will start to flow out of cash and bonds, and into the equity markets. We hope that this will lend momentum to markets, permitting the recovery of at least a portion of what was lost in a very disappointing 2008.

STRATEGY

Consistent with our discipline, Verity manages long-only portfolios, does not employ leverage and maintains a minimum three to five year investment horizon. This, combined with the current level of bond markets, make equities the favoured asset class, current market volatility notwithstanding. Security selection continues to play a key role in the construction of portfolios that will perform well as the anticipated recovery takes hold. Even in a broad recovery, we believe that the market will continue to discount companies whose businesses are not sustainable because of unrealistic projections and expectations, or that have significant debt on their balance sheets. Giving due regard to one of the causes of the current financial turmoil, lenders are going to be much more careful of to whom they lend, and where the credit risk is high, what they charge for the service. We continue to emphasize that strong, well managed, under-levered companies operating in needs-based industries will be stronger than ever in the recovery, attracting capital away from companies that for whatever reason cannot maintain their economic viability.

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