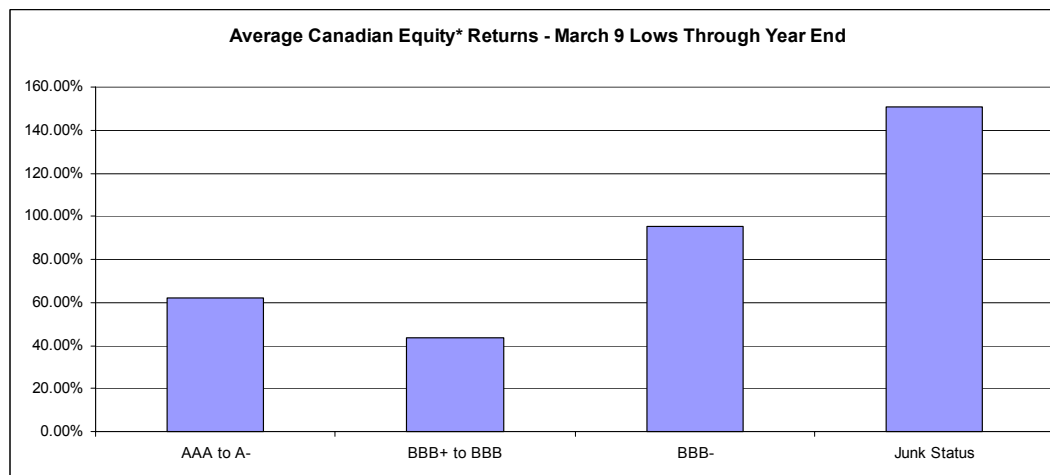


The Challenges of a Volatile Market

The Canadian equity market has demonstrated an exceptional degree of volatility over the past year and a half. At Sionna, we have tried to navigate the market turbulence by staying focused on our fundamental research process. Some of our decisions have proven to be successful, others have been less so. Given the extreme conditions that we have experienced, we thought it would be worthwhile to reflect on the past year and extract what we can from such an extraordinary period in financial history.

Value does not always win.

As the market has soared over 50% from its lows in March, many value managers have been left underperforming their benchmarks. An examination of the average price return of Canadian equities since the rally began (see chart below) reveals that the companies with below-investment-grade credit ratings have enjoyed double the stock price returns as the companies with high quality credit ratings. In other words, the junk has been flying.



**Includes returns from March to October for 80 companies in TSX with credit ratings.*

A recent historical study by the Brandes Institute has shown that, on average, value stocks underperform glamour stocks *during* recessions, and the latest recession appears to be no exception. However, we remain heartened by the results of this same study when the years after recessions are examined, which show that value significantly outperforms over the following one-year, five-year and ten-year periods.

Breaking our own rules can hurt us.

We follow certain self-imposed rules at Sionna, which were created to guide our portfolio construction process and were developed over more than 20 years. The rationale behind these rules is to keep our focus on our core competency, which is stock selection, as opposed to sector or asset allocation. One of our internal rules is that we maintain cash positions below specified levels. Another rule is that we hold sector weight positions that are within a certain range of our benchmark sector weights. In 2008, however, we allowed our cash levels to rise above our typical thresholds and we took an underweight position in the Financials sector that went beyond our typical range. These actions were a reflection of our concerns about the market and the economy in general, as well as our specific concerns regarding the Canadian

banks. While these positions were beneficial during the market's fall, the above-average cash positions and the underweight in banks have been part of the drag on our performance during the market's strong rally. Over the past quarter, we have been opportunistically taking our cash levels down to historically normal levels and we have brought our Financials sector weight within our typical range.

Financial leverage can be perilous.

We tend to be fairly debt-averse when we analyze companies for inclusion in our portfolios. However, the crisis in the credit markets created unexpected hazards, even for companies with seemingly manageable debt levels. Re-financing risk became significant for companies with near-term financing needs, and covenant breaches were a major concern. In particular, two companies that we owned in many of our portfolios, Precision Drilling and Teck Cominco, had undertaken large acquisitions in mid 2008, which significantly increased their debt levels and caused their risk profiles to rise. Given the uncertainty regarding how long the credit seizure would last, Sionna acted to avoid further deterioration should our concerns play out. When the crisis subsided faster than we anticipated, the companies that had greater financial leverage rebounded the most. We acted to protect capital, but our relative performance suffered as a consequence.

Focus on the fundamentals, not the economy.

The news flow regarding economic conditions has been mixed, often including a fair dose of negative statistics. Yet the Canadian equity markets have posted double digit returns over the past year and are trading at price multiples above their long-term averages. History has shown that the equity markets are not highly correlated to economic growth – the markets and the economy can often remain disjointed for considerable periods of time. The chart below shows how the returns of the Dow Jones Industrial Average have diverged considerably from nominal GDP growth over the same time periods. Volatility in the market is often due more to the irrational behaviour of market participants than to the underlying fundamentals, which are usually more stable than the market expects. At Sionna, we remain focused on a consistent and disciplined approach to stock selection that involves bottom-up, fundamental research analysis.

AVERAGE ANNUAL CHANGE (COMPOUNDED)

DECADE	DJIA Stocks	GDP Nominal
1900s	4.1%	5.3%
1910s	0.8%	10.0%
1920s	8.8%	3.0%
1930s	-4.9%	-1.2%
1940s	2.9%	11.2%
1950s	13.0%	6.6%
1960s	1.7%	6.9%
1970s	0.5%	10.0%
1980s	12.6%	7.9%
1990s	15.4%	5.4%
2000s (9 yrs)	-3.0%	4.9%

Source : Crestmont Research, Copyright 2003-2009

As the market continues its spectacular rally, we are wary of the bullish assumptions embedded in investor expectations which have pushed valuations well above long-term averages: the S&P/TSX is currently trading at a trailing price to earnings ratio of approximately 19x compared to a historical average of 14x. In addition, we remain concerned about the unprecedented amounts of ongoing government stimulus. The eventual unwinding of this “Great Experiment”

may have unintended consequences and we think it is prudent to position our portfolios defensively.

Sionna's history shows that we traditionally lag in strong markets, so our relative underperformance over the past year is not unexpected. We are cautiously optimistic that there will eventually be a shift in the markets and our relative value style will again produce positive relative returns. We are incrementally adding to and trimming existing positions to take advantage of the market's volatility, and we are also finding attractive new opportunities amidst the ranks of unloved names.

Marian Hoffmann, CFA
Portfolio Manager