



BCM MID-SPRING 2010 SPECIAL COMMENTARY

Dear Clients,

There have been many significant developments in the global capital markets since my last missive a few weeks ago. In this letter I described many of the macro risks that I was concerned with and a number of these concerns have shown to play out as expected. You have entrusted me to steward your investment portfolios through good times and bad, and it is important to me that you are informed with respect your Portfolio Manager's view on the world during times of market stress.

There is no doubt that price volatility in all global markets and asset classes has risen substantially over the past few weeks. The European sovereign debt issue has continued to unfold and compelled investors to shun so called "risk assets" (global equities, commodities, and certain currencies) in favor of the relative safety of US Treasuries and US Dollar cash. The chart below illustrates the recent performance of many major global equity indices in Europe, North America and Asia.

	Current Price	Performance (percent)					2009
		1 Week	1 Month	3 Months	1 Year	YTD	
CAC 40	3,431	-3.6	-13.8	-9.0	6.6	-12.8	22.3
DAX	5,829	-3.8	-6.4	1.9	18.9	-2.2	23.8
FTSE 100	5,063	-3.8	-11.5	-5.5	16.5	-6.5	22.1
Dow Jones	10,193	-4.0	-8.4	-2.0	22.9	-2.3	18.8
S&P/TSX	11,521	-4.1	-5.1	-1.6	15.8	-1.9	30.7
S&P 500	1,088	-4.2	-9.8	-1.9	22.4	-2.5	23.5
NASDAQ	2,229	-5.0	-11.0	-0.7	31.5	-1.8	43.9
NIKKEI 225	9,785	-6.5	-11.8	-3.3	5.6	-7.2	19.0
S&P/ASX 200	4,326	-6.8	-13.1	-7.1	13.7	-11.4	33.4

Source: Bloomberg

The double-digit declines in many equity markets over the past month are the result of investors acting on a number of cascading fears that may or may not arise from the current debt problems in southern Europe. These fears are essentially as follows:

- i. *Fear of European banking collapse*
- ii. *Fear of Eurozone monetary union dissolution*
- iii. *Fear of a second global financial crisis*
- iv. *Fear of double dip recession globally*

Increased volatility is a concern for markets as it begets additional volatility. It not only causes investor sentiment to become more risk averse, but it also



creates increased uncertainty for business investment. Companies are reticent to make new capital investment if they cannot accurately predict the prices of inputs (such as energy, base metals or labor) in the near future. It is my belief that policy makers, such as the European Central Bank and US Federal Reserve, acutely understand this and are in the process of doing (generally) what is required to stabilize markets.

The Eurozone's problems can be simply assessed as this: Weaker sovereigns need cheaper financing and higher growth in order to pay down deficits and debt. The looser monetary policy presently being implemented - including a weaker Euro - will help eurozone growth. The \$1 trillion bailout package assembled by the ECB, IMF and wealthy Eurozone states will produce a currency devaluation that weak countries require for debt management and strong countries desire for export competitiveness.

Currently, sensationalist media headlines and some vocal "Bears" would have uninformed investors believe that another collapse similar to that of 2008 is eminent. I strongly believe that this is not the case. On the contrary, this is a great opportunity for us to add to equity positions that have been underweight recently. There remain risks to be sure, but as outlined below, many of the Bear arguments can be countered if one takes the effort to investigate beyond the headlines.

- ***Countering the fear of European sovereign debt default***

Despite a lot of macro "noise" to the contrary, the fact is that the cost of funding (as explained by sovereign bond yields) for weaker European countries has fallen significantly from its highs. Greek bond yields in particular have fallen over 5% from their levels two weeks ago. The cost of purchasing insurance on southern European debt (known as a "Credit Default Swap") has also come down significantly. The governments of both France and Spain sold large bond issues late last week that were well received by international buyers at these lower yields, another good sign.

A client asked me this morning what the difference was between the European sovereign debt issue and the US subprime meltdown of 2008, and why I was less concerned with the current environment. It's a good question. The problem with the US subprime mess was that there were extremely leveraged bets (in the trillions of dollars) made on certain types of securities that would become worthless once defaults in the subprime mortgage market exceeded 8%. When this happened vast amounts of capital were completely eradicated from large sections of the global financial system. This will not happen in the European debt crisis. Sovereign countries may owe large amounts of money to banks and other nations, but their capital bases WILL NOT go to zero. Even in the event of a debt default – the worst financial offense a sovereign borrower can commit – the outstanding debt will be restructured in some way such that the lender will receive some substantial percentage of their capital back. Perhaps it is 70%

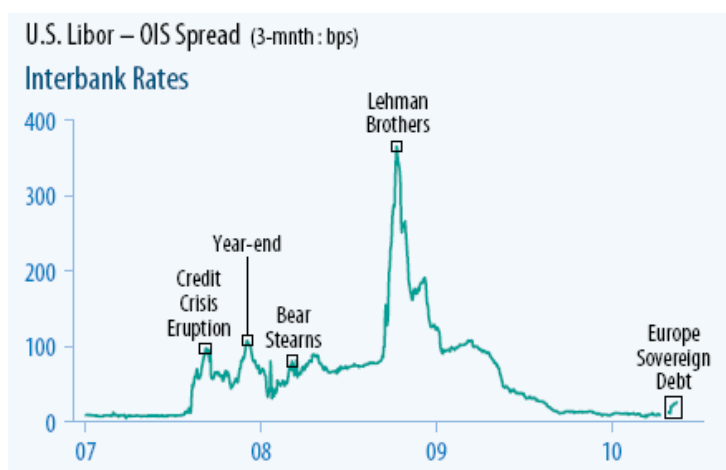
over the existing timeline, perhaps it is 100% over a longer timeline, but it will be paid back. Granted, a sovereign default would have knock-on effects. Country A may need its \$x in debt payments from Country B to fund its own payments of \$y to Country C (welcome to international finance!). The raison d'être of the European bailout fund is to grease the funding wheels of nations affected by circumstances such as these. Capital in the system may be temporarily frozen, but it will not vaporize.

For those so inclined, the best explanation of the US subprime mess I have found is in Michael Lewis' "The Big Short". An essay that summarizes much of the theme of his book can be found here on the website for Conde Nast Portfolio: <http://www.portfolio.com/news-markets/national-news/portfolio/2008/11/11/The-End-of-Wall-Streets-Boom> or by typing "Michael Lewis Portfolio" into Google.

- **Countering the fear of a European banking crisis**

Over the weekend, much fanfare was made about the bailout of a small Spanish lender called CajaSur. The Spanish government has been extremely candid over the past few months with respect to "arranged marriages" it has engineered between weaker and stronger players in its domestic lending market in an effort to bolster the solvency of its financial institutions. When it became clear that the marriage between CajaSur and a stronger partner (named Unicaja – a "caja" is a Spanish savings bank) could not be completed, the Spanish government stepped in to provide support. CajaSur is an extremely small institution with only \$13 billion in outstanding loans - less than 1% of the Spanish market - and its required bailout is a pretty insignificant development in the grand scheme of things for the European theatre.

It's true that the European interbank funding market has become tighter, but only marginally so. A lot is said in the news about "3-month LIBOR", the "LIBOR-OIS Spread", or the "TED Spread". These are all different ways of looking at how much the global banks charge each other for short term loans, and a rise in these metrics essentially indicates that there is growing concern in the risks associated with such lending. The chart below shows that while these risks have grown, the fact is that they are barely higher than historic lows, and are nowhere near the crisis levels of 2008 and 2009.





- **Countering the fear of a double dip recession**

The current macro-level noise is masking the fact that economic fundamentals in many important countries continues to improve. The current challenges in the Eurozone virtually guarantee that interest rates will remain near zero for the foreseeable future, providing the most acute stimulus possible to keep these trends positive. Mortgage rates are back down near their 50-year lows which will support housing in Canada and the US. Also, the recent \$20 drop in oil prices also provides substantial stimulative benefits to the global economy, both in terms of its increase to real economic wealth as well as playing a psychological, sentiment-oriented role.

For those that are worried the Eurozone will drag down global growth in 2010 and 2011, there are a number of reasons why I believe this will not be the case. First, Europe has become a bit player in the global economic engine. Even during the boom years of 2004 to 2007 when global growth averaged 5% per year, the entire Eurozone (including the UK) contributed a paltry 0.4% annualized to this figure. Second, the fiscal austerity packages announced thus far in Greece, Ireland, Italy and Spain are actually lower in the aggregate than the stimulus programs that are being executed in Germany and other strong nations meaning the net effect will still be positive to European growth in 2010 and 2011. Finally, a study of every sovereign debt crisis for the past 800 years (yes, 800) by highly regarded Harvard University academic Kenneth Rogoff clearly shows that it takes between 3 to 5 years for economic effects of a sovereign debt crisis to be felt. There will be pain felt, but not for some time yet.

For reference, exports to the Eurozone and UK account for only 8.5% of Canadian GDP versus emerging markets at almost 11%. A 2% drop in Eurozone growth would only directly result in a meager 0.1% reduction in Canadian GDP, although the indirect impact (currency, commodities) would admittedly be larger.

China is also in the news due to its efforts to slow what it perceives to be speculative bubbles forming in its property and lending markets, and to cool its rate of economic expansion, presently +10%. The market worry here is that as China cools, its demand for energy and base metals will fall and this has weighed to some extent on the equity markets and currencies of Australia, Brazil and Canada. It is important to understand that the statistics coming out of China have always been suspect and that the Chinese government will publish "facts" saying that it is growing at whatever rate it wishes to. It's well documented that China requires 8% annual real GDP growth just to provide employment to its industrializing and urbanizing populations and that to sustain any level materially below that will lead to the Communist party's single greatest domestic fear - civil unrest. China will continue to consume our resources at a voracious pace, I have little doubt.

A final side note that I think will be important to the markets in the near to intermediate future is the level of cash sitting on the balance sheets of North



American corporations. Many companies went into the recession with substantial war chests which have been growing exponentially over the past 12 months given their lean cost structures. It is now estimated that they sit, collectively, on approximately \$1 trillion dollars in highly liquid assets. Too much cash on a corporate balance sheet actually detracts from corporate returns to shareholders (ROE, ROC) and I'd expect that before year end we will see rising dividend payments along with the start of a new wave of mergers.

- ***Opportunity in crisis***

This correction was not completely unexpected nor did it catch us wholly unprepared. Cash was overweight in client accounts, and equities for most clients were either equal or underweight relative to investment policy targets. We also hold significant investments in client accounts composed of alternative strategies that have been providing positive absolute returns (Man AHL) and superior relative returns (Picton Mahoney and Vertex) in the correction environment. All of these have allowed us to weather the recent storm better than most and I'm pleased to communicate that all client accounts remain in positive territory for 2010.

We still view the current market as a correction only and expectations are for equities to end the year materially higher than current levels. Client portfolios employ a long term investment horizon and this correction provides an attractive opportunity to add exposure in areas where a high margin of safety exists. Capturing the equity market risk premium is no free lunch and requires the acceptance of volatility from time to time. That said, risk management is the name of the game and it is your Portfolio Manager's intention to take every care in ensuring our client portfolios are protected from undue downside risk.

Over the past few days we have been selectively adding to the equity exposure in client accounts through both ETFs for foreign exposure and individual securities with attractive dividend yields for Canadian exposure. As long as key technical levels hold and barring a major widening of the interbank financing spreads previously mentioned we will continue to do so. We favor large cap, dividend paying, global blue chips stocks and like what we see in these names from a fundamental viewpoint.

With rates a zero percent, there are considerable headwinds for fixed income. Do not expect to see us make meaningful additions to investments in this asset class outside of one or two really great opportunities we are presently researching.

Vertex is down approximately 5% in May so far and depending on conversations with their investment management professionals over the coming days it is likely we will be trimming positions in client accounts at end of this month as prudent risk management. Simply put, the positions are getting large on a



relative basis for many clients and taking some profits off the table makes sense.

Man's AHL strategy is flat on the month and remains positive on the year, proving again its value as a solid investment holding in challenging markets. The AHL strategy was up 30% in 2008 but had a difficult 2009 as there were few stable trends outside of equities that persisted for any length of time. Liquidity for this investment has moved to weekly from monthly, which is another positive, and we may be slightly increasing allocations to this manager in the near term.

For those clients that have exposure to the Picton Mahoney "Long-Short" strategy, expect to see us switch a portion of these holdings in their lower risk "Market Neutral" strategy when the market regains prior highs.

A final piece of good news for clients is that one of our private shareholdings, the Richmond-based wireless mobile technology company "Mobidia", has recently reached a major milestone. Since last year it has been undergoing rigorous testing to have its technology proven for (1) deployment on the mobile networks of Vodafone, one of the world's largest mobile phone carriers, and (2) incorporated into certain network hardware manufactured by Cisco, one of the world's largest technology companies. Both of these endeavors have proven fruitful and as of last week Cisco / Vodafone have requested that Mobidia enter into a partnership / licensing agreement with them. This initial contract with major global players serves as "proof-of-concept" and our expectation is for there to be much more good news to come in the future from this little company. Mobidia is doing one last little share issue to raise a bit more capital before they go cash flow positive sometime late this year or early next and we have requested an allocation. I'll keep you posted.

In closing, please always remember that hope and fear are not investment processes. When you are informed, knowledgeable and prepared, there's no such thing as a difficult investment decision. We are on top of the market's trades, trends and tails and are looking forward to many exciting opportunities that this environment will present over the coming quarters. Please don't hesitate to call anytime if you'd like to chat more.

Very best,

A handwritten signature in blue ink, appearing to read "A Shortreid".

Andrew Shortreid, CFA
Portfolio Manager
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