

Asset Allocation	Q 3 2007	Q 4 2007
Can. Equity	14%	14%
Income Trusts*	15%	15%
US Equity	10%	10%
Int'l Equity	16%	16%
Fixed Income	45%	45%

*\*Income trusts have a unique return and risk profile and are therefore singled out as an asset class as of this report.*

#### **CANADIAN EQUITY:**

Benchmark: S&P TSX Comp.  
C\$ total returns to Sept. 28<sup>th</sup>, 2007: **11.2%**

#### **INCOME TRUSTS:**

Benchmark: S&P TSX Income Trust TRI  
C\$ total returns to Sept. 28<sup>th</sup>, 2007: **8.2%**

#### **US EQUITY:**

Benchmark: S&P 500  
US\$ total returns to Sept. 28<sup>th</sup>, 2007: **9.13%**

#### **INTERNATIONAL EQUITY:**

Benchmark: EAFE (Net)  
US\$ total return to Sept. 28<sup>th</sup>, 2007: **13.15%**

**Capital markets and economic realities:** “Reality” television and reality is not the same thing. “Flip That House” and other home renovation shows suggest that real estate is booming. The reality is that the US residential market is in “freefall” according to economists and house prices may decline by as much as 18% (National Bank Financial, Hot Charts, Sept. 24, 2007) from their 2006 peak. In the same vein, equity markets (and the Canadian dollar) have bounced upwards and touched new highs in a version of reality that seems at odds with economic fundamentals. At this stage of the market cycle, such disconnects are not atypical, although in this instance it is perhaps more pronounced and longer-lasting than before. For investors (and managers) holding balanced portfolios, it is tempting to capitulate strategic objectives, reduce diversity and in particular add to equity exposure, but, as we argue below, that is exactly what should be avoided. Rather, this late market rally offers other opportunities to generate returns, consolidate gains and secure advantages for the future.

**The grist of economic fundamentals:** A chronic deterioration in the US housing market combined with financial distress among mortgage intermediaries prompted the US Federal Reserve to lower short term interest rates. Notably also central banks in Canada, the US, England and elsewhere have stepped forward on numerous occasions in the recent weeks to inject billions of dollars to prop up market liquidity. Chairman Bernanke will likely continue to lower rates to keep the US economy from tipping over into a recession. It is possible that as a result of the rate cuts, US consumers may renew their spending ways and global commodity and cyclical markets may maintain their upward trend. A plunging US\$, also the product of rate cuts, will help US exports. However, the greater probability is that, with housing of such central importance to US consumer wealth and overall domestic economic and financial health, mid-term US growth is at risk. Likewise, the impairment of trillions of dollars of debt will likely not be cured with a simple cut in interest rates. Indeed with house prices deflating, with major investment and commercial banks holding worthless, riskier or sharply devalued assets on their books, cheaper credit, in all probability, will not become more readily available to consumers. As a result, the US may enter into a period in which lower interest rates do not stimulate growth and asset deflation becomes more pervasive. Consequently, investments in purely US domestic sectors such as housing, consumer discretionary and regional banks, should be viewed as risky.

The meteoric rise in the value Canadian dollar, as discussed in some depth last quarter, will most likely have a deepening impact on Canadian manufacturing and exports (i.e. economic growth) that will not be offset by domestic demand (Western economic strength notwithstanding), or through productivity gains. Up until recently the Bank of Canada was concerned with domestic inflationary pressure. The uncertainty caused by the debacle with mortgage-backed securities and the threat of a US recession, has caused the Bank to rethink its strategy and left it with less room to maneuver. Canadian equity market returns may be expected to soften by as early as Q4 2007.

Equities, in spite of all this background noise and uncertainty, have blazed ahead this year. All leading equity benchmarks (see sidebar) provided in excess of 9% returns on a year to date basis. Non-Canadian returns on a Canadian dollar basis are veiled by the run-up in the Canadian dollar. Typically late market rallies such as this, are fuelled by liquidity, a heightened level of mergers and acquisitions and a widespread reluctance to rebalance portfolios until the last possible moment. (How quickly investors forget the need to rebalance their portfolios: the TSX only recovered from the technology bust in mid-2005 after more than 4 years of being underwater!)

**FIXED INCOME:**  
S&P Broad Composite Bond Index and S&P Short Term Bond Composite  
C\$ total returns to Sept. 28<sup>th</sup>,  
2007: **1.0%** and **2.5%**  
respectively

**Investment strategy: the strength in diversity** Against this backdrop we strive to find a middle ground that will allow for portfolio appreciation but without taking inordinate risks. *To this end, we continue to hold a wide variety of asset categories, both domestic and international, with an emphasis on quality and transparency.* Equity portfolios are now anchored by four key *global sectors* (consumer staples, healthcare, technology and telecommunications) in addition to Canadian exposure (primarily financials and energy) to provide a mix of growth and asset protection. The instruments used are only of the most transparent and liquid variety. Wherever possible, non-Canadian equity gains have been realized in balanced portfolios to generate currency related losses with proceeds reinvested in other non-Canadian dollar denominated (global defensive sector focused) investments. In the mid- to longer term, as the Canadian dollar reverts to historic norms, the strength inherent in such a global portfolio will be fully realized. Fixed income investments are of the highest quality in the event of further credit market instability and tend to be tilted toward the short end of the yield curve as long term rates remain relatively low..

Diversification is not a market timing exercise: the goal of a properly diversified portfolio (one with an allocation to fixed income and both to domestic and foreign equity markets) is to provide longer term asset appreciation and stability, but it is random as to whether diversification boosts near-term returns or can overcome near-term market volatility, such as we are experiencing now. Indeed, excess returns from any asset class in a balanced portfolio, increase the odds that a portfolio will be reset to add asset classes that are out of favor rather than chase after ones after they have done well. The longer a market rally continues, the more at odds a balanced portfolio will seem --- that is until markets reach their tipping point.

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