

Quarterly Commentary: First Quarter 2007

Our normal portfolios were up 1.7% for the quarter. The momentum we saw during the fourth quarter of 2006, one of the strongest quarterly performance periods in two years, became decidedly measured in the first quarter of 2007. Greater volatility, inflationary concerns and the Chinese government's intentions to cool China's overheated market caused global markets to temporarily retreat on February 27 when The Dow Jones Industrial Average fell 3.3%. North American investors shouldered their worst one-day loss since September 2001. Despite geopolitical tensions marked by the detainment of 15 members of the British Navy by Iraq and US trade sanctions against China, most equity funds posted gains in the first quarter. The major indices such as the Standard & Poors 500 Composite Index and the NASDAQ (National Association of Security Dealers Automated Quotations) Composite Index were essentially flat.

The power of investing with discipline

I have often spoken of my disciplined approach to investing. While eliminating unnecessary angst, a disciplined approach frees you to spend more time doing what you enjoy instead of worrying about the markets' ebbs and flows. When we meet to discuss your investments, I focus on the strategies we use to manage your portfolios rather than their short-term performance based on the following proven insights.

Markets really do work

Capital markets are not perfect and prices are not always right, but they are so competitive that it is unlikely an investor can systematically profit from mistakes in the market at other investors' expense.

The active manager is betting against the house

For active managers to succeed, markets must fail. There have been (and will continue to be) managers who outperform the market. History has shown that none can sustain their "run" in the long term. It is also difficult to identify the "hot hands" in advance.

Market timing is risky

Following decades of empirical investigation of capital markets by literally thousands of financial economists, there is no widely accepted or conclusive evidence that market timing works. A successful timing strategy requires the manager to know: when to get in, when to get out, and when to get back into the market. When timing between stocks and cash, for example, the frequency of correct decisions must also be high enough to overcome the higher expected returns of stocks versus cash. The success rate required to beat a buy-and-hold strategy is beyond most investors' (and managers') grasp.

There is no crystal ball ... and you don't need one

Active investment management rests on forecasting, but the future by definition is unknowable. You don't need to know the future to have a successful investment experience. Capitalism is predicated on a positive expected return on capital.

Risk and return are related

Markets are drawn to a state of equilibrium where risk and return are related. Only non-diversifiable risks are rewarded with higher *expected* returns.

Diversification is essential to robust portfolio returns

Diversification is the closest thing there is to a free lunch. Proper diversification increases the likelihood of earning positive expected returns and removes risks you are not paid for taking.

Shut out the noise and bring discipline to the process

Capital markets are noisy: but in the face of many distractions, investors need to maintain their discipline and stick to a long-term investment strategy in order to capture capital markets' rate of return.

Don't get emotional

Investors often display emotions that can lead to poor investment decisions. Over-confidence, self-attribution, mental accounting, fear and searching for patterns are emotions they must overcome to promote wealth and well being.

Costs matter

All investors in aggregate form the market. Given this fact, it must be that the average investor earns the market rate of return, *less fees and expenses*. Managing costs (management fees, operating costs, trading costs, taxes and other costs) allows investors to capture more of the capital market return that is there for the taking. Keep costs down put the odds of success in your favour.

Climbing the walls? Save your energy

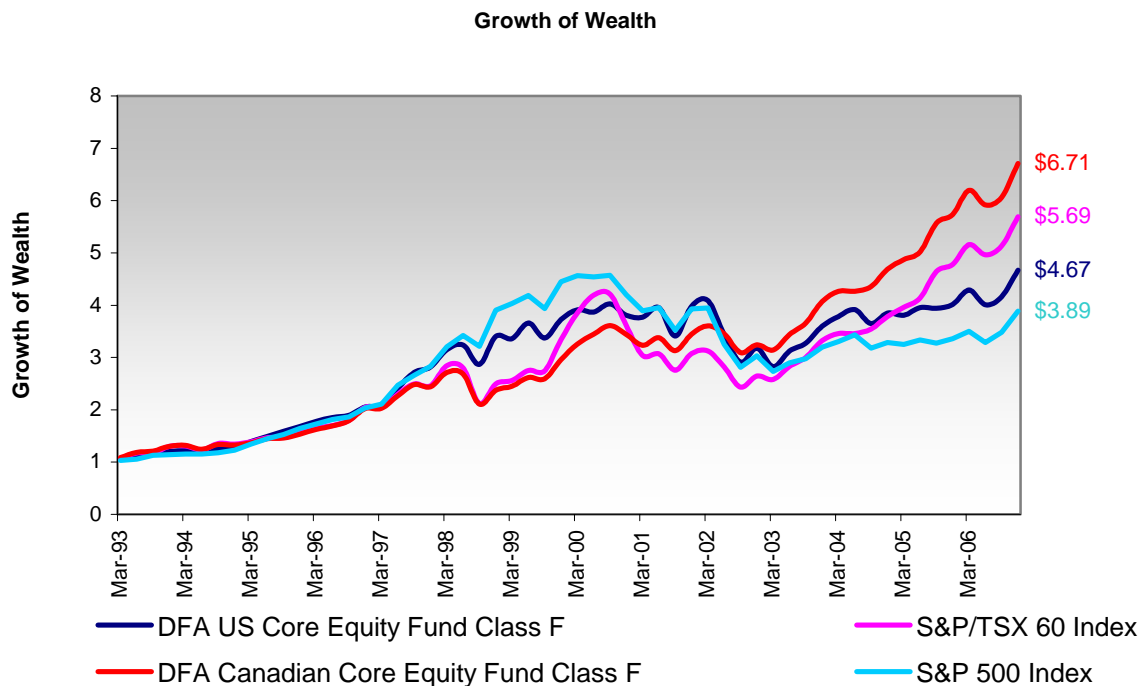
We build our portfolios to be more cost-effective by adding fewer components. By components, I mean those activities that add to the cost of managing your investment portfolio. For example, trading securities, especially illiquid small companies, is expensive. It costs not only in dealer commissions, but also in market impact and taxes.

The more components you have, the more walls you create to hinder the free flow of securities across asset classes, which is necessary to build a strong and diversified portfolio. You need to climb these walls to access good investments, and the resulting cost can undermine performance.

I advocate tearing down these walls to allow securities to migrate from one asset class to another, without added costs. The absence of walls ensures your portfolio can be more precisely engineered to reflect your changing objectives. When you are “wall-free”, you don’t have to sell a stock in one portfolio, then buy it back and put in another portfolio (a costly exercise) to remain diversified.

While investing comes without a guarantee, I am resolved to protect clients from surprises. My watchword is consistency and cost containment. Here are two examples of how this approach helped create robust portfolios over a 14-year period.

\$1 invested in the Canadian Core Equity fund in January 1993 would have grown to \$6.71 by December 2006 versus \$5.69 if invested in the S&P/TSX 60 index. This is a difference of \$1.02 or 18% higher value than in the S&P/TSX 60. Similarly, if you investing \$1 in the US Core Equity fund in January 1993, it would have grown to \$4.67 versus \$3.89 in the S&P 500. This is a difference of \$0.78 or 20% higher value than the S&P 500.



Note: Data courtesy of Dimensional Fund Advisors, simulated prior to June 2004 for Canadian fund and June 2005 for US fund.

The S&P/TSX 60 and S&P 500 are unmanaged indices, which reflect the performance of Canadian and US companies. These indices cannot be purchased by investors.

In the news with Jonathan Chevreau

In writing about the “China Tumble” (mentioned at the outset of this letter) Jonathan Chevreau wrote in “The National Post” (March 5, 2007) that the China market decline “is a refreshing reminder that risk and reward are linked.” In this article, I emphasized the potential benefits (to those investors with the appropriate risk profile and investment horizon) of diversifying in emerging markets, noting it’s better to invest in a basket of them. There are 16 emerging economies with good securities regulations. Assessing their quality is essential when considering any emerging market investment opportunity.

On behalf of the rest of the Bruce team, I wish you an enjoyable spring. Please contact Prithy Serrao, Roger Lee or myself should you have any comments or questions regarding your investments.

Yours sincerely,

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