

Quarterly commentary: Second quarter 2005

Your core portfolio generated a gross return representing a healthy increase over the previous quarter. The portfolio easily outperformed key domestic and global indices.

Some highlights

U.S. real estate holdings in the portfolio performed particularly well against a backdrop of stable growth, low inflation, earnings gains and consumer confidence. These assets generated double-digit returns for investors in one of their best quarters ever.

Fixed income portfolio holdings also performed well over the quarter with each bond category – Canadian, European, Swedish and U.S.– delivering positive returns. Our strategy continues to draw upon geographic and currency diversification while capping maturity levels at five years. Given an average maturity of 3.9 years for the holdings, the portfolio is well insulated against interest rate increases. It is also free from currency risk as non-Canadian bonds are hedged into Canadian dollars while we buy bonds at interest rates higher than their Canadian equivalents.

What triggered this buoyancy?

Stronger-than-expected U.S. economic growth and controlled inflation lifted investor confidence and equity prices in the last quarter. Despite record energy prices during the first quarter, Americans were buying more and home sales reached an all time high in May. A surge in the U.S. job market to its highest level in four years was celebrated in June, which further triggered housing gains.

The strong Canadian dollar held our economy back

In Canada, the Bank Rate remained at 2.50 per cent. The Canadian dollar slumped temporarily with the defection of Belinda Stronach to the Liberal party. Aside from creating some human drama, it did little to help our embattled exports still being hurt by the relatively strong Canadian dollar. While housing starts were up at the end of April, economic activity in Canada slowed due largely to the strong dollar. Business spending and consumer confidence were robust during the quarter.

The global economy also remained strong, slipping only slightly from its record growth rate of 5.1 per cent in 2004 – its strongest performance in nearly 30 years.

Of note...

The streetTRACKS Wilshire REIT Index Fund recently changed its underlying index from the full-market capitalization-weighted version to a float-adjusted market capitalization. I view this as positive since each security is now weighted to reflect the appropriate liquidity.

The London tragedies

While inflicting horrendous suffering on victims and their families, the London bombings of July 7 were viewed by markets as isolated incidents and had a short-term effect. The fact that the banks declined to take action and that markets pretty much returned to previous levels within 24 hours of the attacks tells us there is no need to rebalance your well diversified portfolio.

While terrorism is acknowledged to be the cause of the London tragedies, it was only the widespread losses on September 1, 2001 that forced the U.S. Federal Reserve Board to cut interest rates by 1.25 per cent in the weeks following the attacks.

Avoiding self-inflicted injuries

Remember 2000, when the S&P 500 delivered a record setting four straight years of strong growth? It was the only place for many investors to invest (or so they thought.) More narrowly, some investors put most of their money in technology stocks, some of which ran up eye-popping returns in 1999 and in early 2000. You know the rest of the story and I need not recount it here. I mention it because many investors still look at what's happened over the past year, six months, or sometimes only a few weeks or days, and bet on the *hot* investment. They sometimes leave the markets altogether if they see no prospects or too much volatility for their liking. The result: self-inflicted injuries brought on by the high cost of trying to time the markets and many sleepless nights.

Portfolio diversification is a healthy investment alternative

Many speculators (versus investors who work to a plan) would do well to shun market timing and look to portfolio diversification. Its potential for increasing returns in the long term through reducing both risk and the negative effects of market volatility on the portfolio is impressive.

One landmark study of pension fund managers (I don't believe there is a more recent study of this magnitude) showed that more than 94 per cent of a portfolio's variation of

return depends not on specific investments selected but on how the money is allocated among different types of investments. (Source: “Determinants of Portfolio Performance II: An Update”, *Financial Analysts Journal*, May/June, 1991.)

Portfolio diversification can let you sleep nights while your portfolio has the potential to gain in the long term. Also the equity premium is alive and well in your portfolio – you will be paid for the additional risk you assume over time when you diversify appropriately.

A confident, well-rested investor

The strategies I employ are supported by Dimensional Fund Advisors who have the insight and tools to keep uncertainty in your portfolio to a minimum and to assume only those risks that come with an expected return. Drawing on the DFA team’s expertise and your acceptance of the risk that comes with expected return, you will remain a confident, well-rested investor.

Have a very enjoyable summer.

Yours sincerely,

David R. Bruce CIM CIMA