

Quarterly Commentary: Second Quarter 2006

Our core portfolios were down in the order of 3.5%, slightly more than comparable indexes, over the second quarter. Fixed income performance was flat as investors took shelter during a global correction sparked by interest-rate and inflation fears. U.S. interest rates rose for the 17th consecutive time in June as global banks adopted an equally hawkish stance. This doused the enthusiasm of many investors who had recently ridden a long wave of investments in speculative areas such gold and commodities.

It is important to remember that your portfolio will not always perform in line with comparable benchmarks. This is by design: our team selects investments described as “known sources of additional return” above and beyond those offered by the benchmarks. We favour two criteria in particular when assessing stocks we hold in our portfolios: size and value. Where size is concerned, the return of small stocks have outperformed large stocks by 3.7% and where value is concerned, value stocks have outperformed growth stocks by 5% on average annually over the past 75 years. Please also remember that although your portfolio is well diversified (which helps to mitigate risk) expectations that our returns will exceed those of the benchmarks bring increased risk. This supports the adage that there really is no free lunch.

Who’s on first?

“Who’s on First” was originally performed by comedians Abbott and Costello. It is a staccato commentary that goes back and forth between the two comedians capturing the pandemonium on a baseball field. It is almost impossible to follow, yet became so popular that it earned the duo a place in the Baseball Hall of Fame in 1957.

That leads me to the confusion experienced by many investors when it came time to guess which of these two Dow Jones stocks had the higher return for the first half of 2006.

General Electric which notched a record first-quarter profit of over U.S. \$4 billion. CEO Jeff Immelt reports “Orders for equipment and services were particularly robust, growing 67% and 20% respectively.” Or: General Motors, which reported a first quarter loss of U.S. \$323 million in its sixth consecutive losing quarter. A *New York Times* reporter notes “The sooner this company gets taken over by Toyota, the better off our country will be.”

If you picked GM, congratulations. It was the top performer among all 30 Dow Jones components by a wide margin and up 53.4% for the year to date. General Electric fell 6.0% over the same period.

Who’s on first? Indeed.

It is what it is

I mentioned in my last letter that my job is to maximize your investment return per unit of risk, regardless of market conditions ... and those includes interest rate fluctuations. Without intending to sound nonchalant, if a profitable investment strategy based on changes to interest rates by The Federal Open Market Committee exists, it escapes me. Weston J. Wellington of Dimensional Fund Advisors Inc., who gave me the idea for this comment, has also never heard of such a strategy. In response to the most recent 17 rate announcements, the S&P 500 Index has risen 8 times and fallen 9 times, compared to the previous day's closing. On June 29, the day the Fed voted to raise interest rates, the S&P 500 Index rose over 2% while the Russell 2000 Index rose jumped 3.8%, the largest one-day increase in three and a half years.

Rather than spending time reflecting on the Federal Reserve's next move and every wiggle in the federal funds rate, I respectfully suggest you consider going for a walk and if you have the time, extending it to 18 holes.

What's in a name? Not much.

If asked which of these companies has been a more rewarding investment over the past 40 years, which would you choose - the U.S.'s largest steel producer Nucor Corp. or energy giant Exxon Mobil?

If you picked the former, you can be proud.

For the 40-year period ending December 31, 2005, the annualized return for Nucor was 17.0% (over a five hundred-fold increase) compared to 13.7% for Exxon Mobil and 10.3% for the S&P 500 Index. Despite outperforming brands such as Coca-Cola, Disney and Procter & Gamble over this period, Nucor remains an unfamiliar name to many investors. Failing to own the best-performing stocks hinders performance as dramatically as holding the losers. Broad diversification ensures that both familiar and unfamiliar winners wind up in your portfolio.

Paying attention?

This news item appeared June 1 in the *Financial Times*: "U.S. stocks fell as much as 5% in New York on May 31, 2006 and prompted a fall in the dollar to a three-year low against the Indian rupee on concerns over how the U.S. will finance its growing current account deficit ... the government can ill afford a sharp drop in the capital inflows that finance the economy's soaring imports bill."

Sorry! We got it mixed up. The article really read:

"Indian stocks fell as much as 5% in Mumbai yesterday and prompted a fall in the rupee to a three-year low against the dollar on concerns over how India will finance its growing

current account deficit... the government can ill afford a sharp drop in the capital inflows that finance the economy's soaring imports bill."

Given the number of commentators expressing alarm about the size of the U.S. trade deficit, how many investors would have caught this error?

How much is that benchmark in the window?

Sorry, it's not for sale.

Many investors compare the results of their investment portfolio (whether active or passive) to a given benchmark. However attractive, a benchmark or index must forever remain in the store window – no one can invest in one. Many look longingly through the window wondering why their portfolio's returns cannot look as appealing.

The reason is that the gross return of an index is not available to investors due to the various costs associated with investing. Their basis of comparison should therefore be their "investable" alternative and for many people that alternative is an exchange-traded fund (ETF). An ETF is a security that tracks an index or a commodity but trades like a stock on an exchange. ETFs provide many benefits, including the diversification of an index. However, fees, expenses, reconstitution effects and the drag resulting from ETF's being required to hold cash generates costs of investing in this vehicle. It is essential to consider all that comprises an "investable" alternative when eyeing those unattainable benchmarks.

Lest we forget

As the second quarter of 2006 drew to a close, a large Canadian financial institution noted in its market commentary: "The performance of the TSX over the past four weeks has been a painful reminder of the need to remain well-diversified and to avoid becoming over-exposed to any one sector or individual stock."

We could not have said it better ourselves.

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

Yours sincerely,

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