

Quarterly Commentary: Second Quarter 2007

Our normal portfolios were down 0.7% for the quarter, outperforming the benchmarks. Canada and emerging markets posted strong returns to shore up performance. And while your exposure to 16 established emerging markets including Brazil, India and China constitutes only 3% of your normal portfolio, they boosted performance while adding to the diversity within.

The rise in long-term interest rates through June forced many investors to rethink the case for equities. Inflation has come to the forefront once again as traders speculate on the future of monetary policy. The Canadian dollar strengthened, causing market watchers to speculate on its effect on import and export prices. Meanwhile, worries of a deeper downturn in the U.S. housing market and unease over possible fallout from leverage in the financial system all contributed to a debt market sell-off.

The circle of competence

I have spent a large portion of my career gaining a full understanding of the benefits enhanced index investing can bring to my clients and have tremendous confidence in this investment process.

As Warren Buffett notes, “If we can’t find things within our circle of competence, we don’t expand the circle. We’ll wait.” I apply this proven strategy daily. If I don’t understand or see value in an investment, I pull back and wait for another with which I am completely comfortable.

The circle of competence surrounding your core portfolios does not exclude my exploration of new ideas, as long as they are consistent with our investment objectives and strategies. When you consider all you gain from your core investment portfolios, (including fee and general cost management, tax and trading efficiency and comfort in your investment decisions) I believe you are best to remain within the circle. I will always keep abreast of developments within our industry. But I remain a specialist who relies on enhanced index investing to reward my clients, rather than one of the generalists who proliferate in Canada’s investment industry.

Meeting of the minds

The ScotiaMcLeod National Conference is the only Canadian gathering of its kind where financial advisors within the same organization hold a conference to share knowledge that will help them enhance their practice management abilities and further inspire them in the process. Some 350 ScotiaMcLeod sales representatives and senior managers (who attended as guests) gathered at the end of May in Banff for the third annual event. My

colleagues and I paid our own way and gained tremendous value for our efforts. As an indication of the generous spirit, which characterized the event, we raised \$250,000 for the Terry Fox Foundation. I was honoured to be invited to speak in four of the eight learning modules. My topic was running an excellent business and the benefits it brings advisors and their clients.

On (golden?) hedge fund pond

The \$6.5 billion collapse last year of the Amaranth Advisors LCC hedge fund continues to make waves in the hedge fund pond. (Amaranth is defined as a cosmopolitan genus of herbs.)

On March 22, 2005, “National Post” writer Jonathan Chevreau reported my view that the “best hedge fund for investors is simply a low-cost, well-diversified portfolio.” He wrote, “Bruce strives to provide comparable simplicity and transparency for clients...clients and advisor agree to the asset allocation, which may include a global fixed-income fund and equity funds tilted toward value and small companies.”

I was quoted further saying that, “Hedge funds are best suited to institutional investors who have full-time staff to keep on top of these ‘black-box’ under-regulated investments.”

Fast forward to June 5, 2007, in which the “Globe and Mail” marked the closing of the Abria Diversified Arbitrage Trust. “Clients voted with their feet,” said Abria management, noting that investors would no longer shoulder the fixed costs that come with managing a fund that is now too small.

Writer Boyd Erman noted that, “Funds of funds are designed to protect investors from volatility and blowups in any single hedge fund by spreading money over many funds.” In fact, Abria took its name from the root word “abri”, which means shelter in French and protection in Latin.

Our resolute loonie

The Canadian dollar averaged 91.09 cents US in the second quarter, up from 85.35 cents in the previous quarter and 89.11 cents a year ago.

As a major trade partner of the US, the increasing value of the Canadian dollar against the US dollar put a crimp in export growth. In the second quarter, a few big factors loomed large for the Canadian Dollar, namely exports, domestic growth, the next big trend in commodity prices and US demand for Canadian products.

The strong Canadian dollar and low prices pushed newsprint and lumber producers to their lowest profitability in years, as Canada's paper and forestry companies noted the ill effects of the resolute loonie on their second-quarter results.

It is worth mentioning that currency volatility has much less impact than equity volatility on investors. Holding investments denominated in different currencies is a very worthwhile diversification strategy. Bond investors should take note that we hedge instruments with non-Canadian exposure back into Canadian dollars, thus eliminating risk that comes with investing in foreign currencies. This is because bonds are less volatile than equities. Also, most non-Canadian holdings are reported in Canadian dollars, and the rise and fall of the loonie has no effect on the value of your investment unless you sell it.

The 20-punch bus ticket. All aboard.

I have noted that Warren Buffet has long maintained that activity for the sake of activity can damage long-term investment returns. I agree with Buffett that too many “helpers” can drive up fees and encourage unnecessary movement within a portfolio when it is better to stay the course and forget about chasing performance. This assumes that a portfolio is properly structured in the first place. (As the Oracle of Omaha has suggested, “It won’t be the economy that will do in investors; it will be investors themselves.”)

In managing your investments, I abide by Buffett’s view that everyone would be a better investor if they restricted themselves to just 20 investment decisions in their lifetime. Buffett refers to this as the “twenty punch lifetime bus ticket” for investments.

I liken some investors’ urges to see activity within their portfolios to children who must repeatedly shake the clear plastic container so they can watch the snowflakes randomly swirl around the snowman or wood cabin. (The only difference between that and shaking up an investment portfolio is that harmless activity doesn’t cost anything.) By refusing to be tempted by activity for activity’s sake, you will allow yourself to enjoy a more consistent and profitable investing experience.

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.

Yours sincerely,

David R. Bruce
Associate Portfolio Manager