

Quarterly Commentary: Third Quarter 2006

Our core portfolios generated a gross return representing a healthy increase over the previous quarter. Most of the loss in the second quarter was recovered in the third.

All asset classes had a positive return except U.S. Small companies, which lost about 0.5% over the quarter. Very strong returns were delivered by the U.S. Real Estate holding (+9.2%) and international value stocks (+6.6%). The Canadian holdings performed well but lagged the rest of the world led by the U.S. and United Kingdom. Energy was the worst performing sector. Diversification is indeed worthwhile.

When science trumps fad

There is a huge difference between speculating and investing. The former requires nerves of steel. The latter requires steely discipline. As a scientist by training, I subscribe to the latter. When you reject costly speculation and guesswork, investing really becomes a matter of identifying the risks that bear compensation and how many of these risks to take. Financial science identifies the sources of investment returns.

I recently had the opportunity to exchange ideas with two of the originators of the exacting science that makes these returns possible at a Dimensional Fund Advisors conference with Ken French and Meir Statman. French is the Carl E. and Catherine M. Heidt Professor of Finance at the Tuck School of Business, Dartmouth College. He is the author of numerous articles appearing in, for example, the *Journal of Finance* and the *Journal of Financial Economics*. Statman is the Glenn Klimek Professor of Finance at the Leavey School of Business, Santa Clara University. His research focuses on behavioral finance. He attempts to understand how investors and managers make financial decisions and how these decisions are reflected in financial markets. Both brought valuable insights to the conference. Key among them was that learning never ceases and good advisors focus on the wealth and the well-being of their clients.

I own that!

It's always a thrill to own a stock that doubles in price, especially over a quarter. AnorMED Inc., a Canadian biopharmaceutical company is one such stock, doubling its price this quarter. With a new strategic plan and a clearly inspired new board of directors it remains focused on discovering, developing and commercializing new therapeutic products in the areas of hematology, HIV and oncology. Your Canadian Core holding invests in the entire class of biopharma firms such as AnorMED Inc., thus positioning itself to benefit from other potential good news stories in the industry.

Lest we forget ... again

“Where was the hedge?” was one seasoned analyst’s response to the collapse of Amaranth Advisors LLC, a prominent hedge fund recently felled by trading losses of \$6 billion. The six-year-old firm and former investor magnet had attracted over \$9 billion in assets from global institutional heavyweights. Amaranth (Greek for “unfading”) caused the San Diego County Treasurer to comment in the *New York Times*, “Maybe knocking the lights out every year shouldn’t be the goal.”

There are about 9,000 hedge funds managing more than \$1.2 trillion (U.S.). They are described as an “accident waiting to happen,” in a recent *GlobeinvestorGOLD.com* column. It likened the aftermath of such an upset to a passage from Victor Hugo’s last novel, *Quatrevingt-Treize* describing, “the effect of a cannon loose on the deck of a ship in the English Channel.” In the same column, Warren Buffet likens such an event to “a cat carried by its tail.”

Losses are hard to recover...

Preservation of our clients’ capital is one of our most important responsibilities. As a result each investment holding must have a clear and positive relationship between risk and return.

The following table illustrates the difficulty inherent in making up losses:

Loss in 2005	Gain Required in 2006 to Break Even
10%	11%
25%	33%
50%	100%
75%	300%
100%	Won’t ever recover!

Our philosophy is to deliver steady performance according to each client’s ability to take on risk.

Choosing the right financial advisor

Paul Brent interviewed me recently (October 5, 2006) for his *Toronto Star* article about the challenges of choosing a financial advisor. I noted that our industry needs to better explain what we do, how we are compensated and how to accurately assess our performance. My quarter-century as an advisor has shown me that the best relationships between advisor and client begin with two-way communication about the expectations each party has of the other.

The seven year itch and the Dow

As the Dow Jones Industrial Average rose recently to pass its previous high set on January 14, 2000, many investors had grown tired of trendless stock market results. For them, the decision to shake the doldrums using market-timing strategies to create more exciting returns has been a costly waste of time.

Mark Hulbert, an investment analyst, has tracked market-timing newsletters since 1980. He confirms that market timing, based on one of the best newsletter's timing signals, underperformed a buy-and-hold strategy by 1% over the past 15 years. The after tax difference was even greater.

Investing in your U.S. Core holding during this period, when the Dow was flat, resulted in a \$1 investment growing to \$1.43. There is a huge amount of science used to engineer your portfolios.

On behalf of the rest of the Bruce Team, I wish you a restful and enjoyable fall. Please contact any one of us should you have a question or comment about your financial well-being.

Yours sincerely,

David R. Bruce
Associate Portfolio Manager