



## **Pinnacle Canadian Small Cap Equity Fund First Quarter 2009**

### **Market Environment**

For the first quarter of 2009, the BMO Small Cap Index (BMO SCI) closed up 1.3%, a welcome rebound after the 27.8% decline in the fourth quarter of 2008 and a 46.6% decline for all of 2008. This nominal rise, however, hid a lot of continuing volatility. During the quarter, the BMO SCI initially rose 8.8% then fell almost 20% before climbing back to close in positive territory. Only two of the ten small cap sectors rose in the quarter, with the returns of the ten sectors scattered from a high of 24.6% for the Materials sector to a low of -19.6% for the Industrials sector.

### **Performance**

The portfolio underperformed the BMO SCI in the first quarter. Our relatively heavy weight in the Industrials sector and our minimal weight in the Materials sector accounted for much of this difference. Gold stocks, which make up a major component of the Materials sector, performed extremely well in the period. We have historically had little exposure to gold stocks as their profitability, valuation and risk parameters have rarely met our investment criteria. Beyond this, the portfolio's heavy exposure to certain high-yielding companies proved to be detrimental, as this financial and economic crisis caused some of these companies to cut their payouts. These companies, which included Russel Metals Inc., Mullen Group Income Fund, and Transat A.T. Inc., were heavily penalized in the market as a result, even though they remained, in our opinion, viable, wealth-creating companies. During the quarter, we added one new name to the portfolio: MAXIM Power Corp., an independent power-producer with assets in Western Canada, the US Northeast and France that we felt was well-positioned and attractively valued. We eliminated one company: Exco Technologies Ltd., a manufacturer of automotive components, extrusion dies, and large casting molds. We maintained a low cash weight in the portfolio throughout the quarter, taking advantage of opportunities to build weights in specific companies when other investors were actively selling.

### **Outlook**

We continue to expect a tough economic period in 2009. We are experiencing a severe economic and financial crisis which will take time to get through in spite of the massive stimulus, spending and monetary programs that have been initiated. We believe, however, that small caps have discounted much of these tough conditions. We expect them to be volatile over the course of the year but think they will provide positive returns. For investors with a longer-term investment horizon, we think small caps are positioned to move materially higher when the market gains confidence that an economic recovery is on its way. While we

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are still not convinced that this will happen in 2009, we do know that small caps have historically performed very well coming out of a recession.

As a result of our continuing stock selection work, we have built up our portfolio weight in the Information Technology sector to its highest level ever (at just below 8%). At the same time, this sector of the BMO SCI is at its lowest level since the Tech Bubble burst in year 2000 (currently less than 5%). While other investors have soured on this sector in the past few years, we have found and invested in some attractively-valued world-class companies, including Constellation Software Inc. and Descartes Systems Group Inc. In the midst of the financial crisis, we have also uncovered several strong niche companies in the Financials sector which has resulted in our weight in this sector rising to almost one-quarter of the total portfolio. Here, we have built our positions in securities like Altus Group Income Fund, Parkbridge Lifestyle Communities Inc. and Home Capital Group Inc. Our weight in the Financials sector is only exceeded by our weight in the Industrials sector and it is closely followed by our exposure in the Energy sector. Overall, the companies in the portfolio are in very strong financial condition and are continuing to generate significant levels of earnings and cash flow. On a weighted-average basis, our securities provide a double-digit earnings yield and a payout yield of approximately 5%.

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