

Connor, Clark & Lunn Investment Management Pinnacle Strategic Balanced Fund First Quarter, 2009

Global equity markets reached new multi-year lows during the first quarter of 2009, before rallying in the month of March and recovering a portion of the losses. For the quarter, global equity indices fell on average by 10% while the Canadian market ended only 2% lower thanks to its greater commodities exposure and better performing financials. The Canadian bond market provided positive returns and the environment for credit improved modestly in Canada as yields on both financial and non-financial issues moved lower. Meanwhile, longer-term government yields rose modestly suggesting that investors are gaining confidence that government and central bank policy actions will ultimately be successful in reflatting the economy.

The portfolio return was negative and lagged the benchmark because of underperformance in the bond and equity strategies. Asset mix was slightly positive thanks to a small underweight in global equities.

The first quarter proved to be a difficult environment for our Canadian equity growth process. We experienced a partial retracement of the strong gains that were generated from our quality factor during the second half of 2008, and our momentum indicators struggled given rapidly changing market trends. Stocks with attractive value characteristics also had a poor start to the year, which is not uncommon in the later stages of a protracted bear market as earnings evaporate and valuation multiples are adjusted lower.

Although small cap Canadian equities lagged the broader markets, the small cap strategy in the Fund was significantly ahead of the S&P/TSX Composite Index. The strategy benefited from strong performance in holdings such as First Quantum and Inmet in the materials sector, RuggedCom in technology and Celtic Exploration and Addax Petroleum in the energy sector.

Global equities in the Fund trailed their comparative benchmark as a result of poor stock selection in European financials such as Deutsche Bank and ING and UK insurers Aviva and Legal & General. As well, we were underweight the UK mining sector, notably BHP Billiton and Rio Tinto, which hurt returns. Our country decisions fared better such as the underweight to Japanese equities which were pushed lower because of Yen weakness. Emerging market exposure in Asia made a positive contribution to returns as sentiment in the region was helped by a rally in the domestic Chinese equity market. We believe that the steady growth sectors of healthcare, telecoms, selected IT and media will return to favour as investors are squeezed out of cash by super low deposit rates and have positioned the portfolio accordingly.

Once again fixed income detracted from performance because of corporate bond security selection and falling income trust prices. We had an overweight in bonds issued by global financial institutions that were hurt by growing concerns over potential nationalizations. We strongly believe the small improvement in corporate spreads witnessed so far in 2009 will continue but we do not expect a complete retracement in the near term. That said investors with significant exposure to corporate credit will be rewarded for their patience given the significant yield advantage offered by this area of the market.

We expect that equity market volatility will continue in part because of the tremendous number of cross currents that investors are dealing with. For example, while valuations appear to be extremely attractive, earnings estimates continue to be slashed; while the level of fiscal stimulus is unprecedented, business downsizing and job losses continue to mount; and while monetary policy is expansive, the corporate debt rates remain stubbornly high.

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We believe it is still too soon to conclude that the market's recent optimism signals the end of this bear market. Before the all clear signal can be given there needs to be more progress in righting the U.S. housing problem, stabilizing employment, and further re-capitalizing of the banking industry to meet the tsunami of loan losses coming from commercial real estate defaults and rising credit card delinquencies. In addition, it is imperative that credit markets continue to heal through more liquidity and lower spreads. Until there is more progress on these critical factors the optimal strategy is to have a small overweight in Canadian stocks versus an underweight in foreign equities and a market weight in fixed income with an emphasis on corporate debt.

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