Quarterly Pinnacle Review

MARKET UPDATE

How Will the Confidence Game Play Out?

Stabilizing the banks remains the first order of business. The $787 billion stimulus plan is unlikely to generate a sustained recovery if it doesn't restore the flow of credit to the economy. During the intermediate term, U.S. economic growth will have to become less dependent on consumer spending. The government will also have to restore confidence about its role in the markets and plans for economic growth before investors regain their appetite for risk.

INVESTMENT COMMENTARY

Making the Most of Niche Mandates

When it comes to increasing a portfolio's potential returns, while managing risk, there are a number of effective strategies that can be followed, be it asset allocation, geographic or style diversification or a combination of the three. A strategy that is less often talked about is the use of niche mandates to provide an additional layer of diversification for a portfolio of core holdings.

FEATURE MANAGER

Finding Value with Scheer, Rowlett & Associates Investment Managementt

For this quarter's Pinnacle review, we are pleased to introduce Scheer, Rowlett & Associates Investment Management Ltd. to the Pinnacle Program. They recently replaced BonaVista Asset Management Ltd. as the portfolio advisor to the Pinnacle Canadian Value Equity Fund.

The Pinnacle Program™

ScotiaMcLeod™

SPRING 2009

David J. Ritcey
Financial Planner

The Ritcey Team

ScotiaMcLeod
1 Webster St.
Po Box 456
Kentville, NS
B4N 3X3
Tel: 902-678-0048
Fax: 902-678-4449
Toll Free: 1-877306-0010
Send an Email
http://www.ritceyteam.com

MARKET UPDATE

How Will the Confidence Game Play Out?

Northern Trust Global Advisors

Significant investor uncertainty continues to be the rule, not the exception. Volatility in stock prices, as measured by the VIX index, has plateaued at 40%, down from the highs set in the late fall but well above long-term levels.

Investors have reacted to this volatility by continuing to increase their cash holdings - data from Ned Davis Research found that money market mutual fund assets recently reached a record 42% of total stock market value, compared to the prior peak of 24% reached in 1982 and again in 2003. Corporations are acting in similar fashion. Their lack of confidence in future demand - new orders for durable goods fell 26% in the most recent period - has led to job losses totaling 4.4 million.

This downward spiral likely will continue until investors and corporations regain confidence, which will require stabilizing the major banks, clarifying government's ongoing role in the economy and being able to forecast a durable economic recovery.

The recent financial sector rally, in which a 39% jump in bank stocks led to an 11% increase in the S&P 500 Index, is a clear indicator of how important stabilizing the banks is to the overall stock market. The primary catalyst for this rally was positive commentary from certain leading bank executives about the profitability of their operations at the beginning of this year. (To a lesser degree, talk of regulatory action on short-selling rules and mark-to-market accounting may have helped.) Good news from the banking sector is important not only to show that the U.S. economy may be moving beyond the worst of the financial losses, but also that banks may be in a position to begin increasing their risk taking.

The banking system is changing, and the market is working to understand how. The new system likely will be smaller and more risk averse, but more stable. Although a more stable financial system should boost confidence, its increased risk aversion and reduced leverage may lead to slower growth. The massive engines of credit creation that drove growth during the last two decades likely won't be replaced.

A newer concern weighing on investor confidence involves the role of government, both in the financial rescue process and the ongoing management of the economy. Since the unexpected bankruptcy of Lehman Brothers in September 2008, investors have been unsure that the existing rules of the capital markets will prevail. Until investors feel confident the existing rules, including the sanctity of contract law and the seniority of claims, will prevail, risk-based capital will stay on the sidelines and recovery will be delayed.

The only silver lining in the rapid pace of the current economic downturn is that the pace at which the economy reaches maximum contraction potentially also is accelerating. The cyclical slowdown in consumer and business spending seen during a typical recession has been multiplied this cycle by the contraction in credit - but this can reverse with improvement in the credit markets.

Retail sales in January fell nearly 10%, reflecting both a lack of consumer confidence and scarce credit. Even though there seems little doubt that a sustained increase in the national savings rate will prove a longer-term headwind to consumer spending growth, a cyclical bounce back seems likely with some improvement in credit creation.

Of course the stock market is, at the end of the day, a discounting mechanism. We feel that many, but maybe not all, of these problems are reflected in current stock prices. The high level of losses from the financial and auto companies complicates the analysis, but a couple of measures do provide good insight.

In terms of the S&P 500 Index as a percentage of the overall economy, the Index has declined from a valuation peak of 135% of gross domestic product in 2000 to approximately 50% today. On a longer-term basis, it has returned to levels last seen in the late 1980s, when 10-year bonds were yielding 8%. Looking at price/earnings (P/E) multiples, the median P/E ratio for the S&P 500 Index has dropped to 12, compared to a median level of 16.5 during the last 37 years. This reflects the significant risk premium investors are demanding today.

So how will the confidence game play out? Stabilizing the banks remains the first order of business. The $787 billion stimulus plan is unlikely to generate a sustained recovery if it doesn't restore the flow of credit to the economy. During the intermediate term, U.S. economic growth will have to become less dependent on consumer spending. Developing countries will need to boost their domestic consumption, expanding U.S. export market opportunities, for a more balanced global economy.

Lastly, the U.S. government will have to restore confidence about its role in the markets and plans for economic growth before investors regain their appetite for risk. The U.S. government is implementing additional plans to stabilize the banking system, including the recent quantitative easing program, and is just starting to implement the stimulus program.

The Canadian financial system seems to have avoided the worst of the global credit crisis due to the conservative lending policies practiced at the major banks and prudent oversight by bank regulators. However, the economic downturn continues to take its toll on Main Street as layoffs mount in the traditional cyclical industries of manufacturing, construction, and natural resources. With the unemployment rate hitting 8.0% in March, it seems optimistic to expect a near-term recovery in economic growth. Much of prior years' excess - both debt and consumption - will need to be worked off before growth can restart anew.

Despite the barrage of gloomy news, Canadian markets should be well-positioned to benefit from the eventual recovery of the global economy. While energy and materials prices have fallen significantly from record highs, we have seen some recovery of late as investors came to realize that the world still needs our resources. A great deal of patience may be required before economic growth begins to stabilize, but when that does occur, Canadian equities should benefit strongly from renewed trade and investment.

For more information on market outlook and performance, please contact us.

ScotiaMcLeod™

INVESTMENT COMMENTARY

Making the Most of Niche Mandates

When it comes to increasing a portfolio's potential returns, while managing risk, there are a number of effective strategies that can be followed, be it asset allocation, geographic or style diversification or a combination of the three.

A strategy that is less often talked about is the use of niche mandates to provide an additional layer of diversification for a portfolio of core holdings. These are the mandates that do not necessarily come first to mind when building a portfolio - high yield income and small cap equities would be examples - but, because they invest in less efficient markets, they provide solid opportunities to outperform nonetheless.

The Pinnacle Program features a number of unique niche mandates to its suite of Funds - all of which are designed to help increase a core portfolio's potential returns, while managing risk. Let's examine each in turn.

Pinnacle High Yield Income Fund
High yield bonds can be very effective in providing additional portfolio diversification because their return patterns are not correlated to any other asset class. They can, for example, outperform when equity markets are underperforming and they generally offer higher coupon rates than other fixed income securities. They also tend to have shorter maturities and durations which, in turn, make them less vulnerable to interest rate fluctuations.

For the Pinnacle High Yield Income Fund, Guardian Capital LP, the money manager of the Fund, conducts an extensive financial analysis with a focus on cash flow, ratio analysis and bankruptcy tests. They also use downside analysis to test for downside risk exposures and limit their interest rate risk through implementing tight constraints on the Fund's maturity and duration. Other key factors that are taken into consideration include the quality of the issuer's covenants and management, as well as the quality of their assets.

Pinnacle Global Real Estate Securities Fund
Despite the recent market turmoil, real estate continues to play a key role as part of an overall asset allocation strategy.[1] Investing in Canadian, U.S. and non-North American real estate stocks and Real Estate Investment Trusts (REITs) can provide the potential to improve portfolio returns as REITs, in particular, typically have higher yields than equity or fixed income securities and can provide a solid hedge in an environment of rising inflation.

The Pinnacle Global Real Estate Securities Fund seeks to achieve long-term returns through income and capital growth by investing primarily in Canadian, U.S. and non-North American real estate stocks and REITs. Citigroup Alternative Investments (CPI), the money manager of the Fund, applies a comprehensive, consistent, disciplined and global approach to identifying potential return and risk in real estate investments. They utilize a consistent methodology to project levels of expected return and risk within a comprehensive global universe of over 500 real estate companies. They select only those companies, which they believe present superior expected returns for the risk undertaken, by exploiting market inefficiencies that include local market growth trends, development pipelines, pricing of leverage and factors such as quality of management, specific asset quality and market volatility.

Pinnacle Canadian Small Cap Equity Fund
Small cap equities typically offer superior long term returns compared to their large cap counterparts. These companies tend to have higher growth potential, more room for expansion and are able to adapt more quickly to changing market conditions. The Pinnacle Canadian Small Cap Equity Fund strives to achieve superior long term returns through investing primarily in stocks of Canadian small and medium capitalization corporations that are creating wealth and are also trading below their intrinsic value. To do so, Mawer Investment Management, the money manager for the Pinnacle Canadian Small Cap Equity Fund, takes a long-term, bottom-up, value-oriented approach that focuses on finding companies that offer a higher Return on Equity and lower Price-to-Earnings and Debt-to-Equity ratios.

Pinnacle International Small to Mid Cap Value Equity Fund
As with the Canadian small cap companies, international small to mid cap companies tend to have higher growth potential than their large cap counterparts. These companies are usually in the growth phase of the business life cycle and the opportunity for significant business expansion is more evident versus their large cap counterparts - especially in the international markets.

The Pinnacle International Small to Mid Cap Value Equity Fund seeks to achieve superior long term returns through capital growth using a value-oriented investment style, by investing primarily in stocks of small and medium capitalization companies in Europe, Australia and the Far East. Investing in these countries tends to be beneficial because their small to mid cap companies tend to be covered by fewer analysts than their Canadian and U.S. counterparts which, in turn, provides Munder Capital Management, the money manager for the Pinnacle International Small to Mid Cap Value Equity Fund, with the opportunity to invest in undiscovered companies which tend to be priced inefficiently and subsequently offer more upside potential.

For further information on niche mandates or the benefits of including them in a portfolio, please contact us.

The Pinnacle Program™ is an asset allocation service that consists of the Pinnacle Program Funds. Commissions, trailing commissions, management fees and expenses may be associated with mutual fund investments and the use of an asset allocation service. Please read the Pinnacle Program Funds prospectus before investing. Mutual funds are not guaranteed or insured, their values change frequently and past performance may not be repeated.

[1] Source: "The Right Time for Global Real Estate?" *Point of View, Global Investment Solutions from Northern Trust*, October 2008, pp. 3-5.

ScotiaMcLeod™

FEATURE MANAGER

Finding Value with Scheer, Rowlett & Associates Investment Management

We are pleased to introduce Scheer, Rowlett & Associates Investment Management Ltd. (Scheer Rowlett) to the Pinnacle Program. They were recently added to replace BonaVista Asset Management Ltd. as the portfolio advisor to the Pinnacle Canadian Value Equity Fund. Scheer Rowlett manages approximately $4 billion in assets, specializing in value-oriented, Canadian equities and balanced mandates. Scheer Rowlett is a member of the Connor, Clark & Lunn Financial Group of companies, one of Canada's largest and fastest growing asset management firms whose affiliated managers are collectively responsible for the investment of over $27 billion in financial assets on behalf of institutional, private and retail clients.

Below is a summary of our recent interview with Scheer Rowlett.

Can you please describe your investment philosophy and process?
We are a bottom-up, value oriented Canadian equity manager that focuses on investing in companies trading below their intrinsic value - based on their return on invested capital.

When selecting stocks, we employ a four stage investment process:

1. **Quantitative Screening** - Identify cheap companies in the S&P/TSX Composite Index using traditional valuation metrics such as Price-to-earnings, Price-to-cash flow, Price-to-book value.

2. **Verify Discount** - Use fundamental research and management interviews to determine rationale behind market discount. For those cheap companies, we try to understand why they are cheap - are they facing fundamental balance sheet issues, market positioning challenges, or are they just out of favour?

3. **Determine Profit Sustainability** - Look at the company's business operating environment. If a company has a competitive cost structure, is run by a competent and financially committed management team and is providing a good/service that the market wants or needs - then it should be allowed to earn a decent Return on Equity (ROE). If the ROE is excessive, a competitor will likely come into the market in the future. Simply put, we believe economics will win over a reasonable time frame.

4. **Security Valuation** - Estimate fair value (price target) using discounted cash flow analysis, determine what the value should be over the next 1-3 years, and assess a target price.

When constructing portfolios, we are mindful of the upside potential in individual names but also in managing the overall risk and diversification of the portfolio, and thus use a number of tools to measure risk. One of the risk control measures we employ includes having exposure to at least 7 of the 10 major sectors in the S&P/TSX Composite Index, and limiting sector exposure to +/- 7% on an absolute basis, and +/- 25% on a relative basis. In addition, we run quantitative reports on a regular basis to serve as a check and balance against what we intuitively know when tracking our weights relative to the benchmark Index.

We do take risks in our portfolio; however, we want to make sure that we are well compensated for these risks. Our ultimate objective is to provide our clients with solid returns over a reasonable time frame without exposing them to undue (or unacceptable levels) of volatility or risk.

We have a firm sell discipline, which includes selling when there is a change in fundamental outlook either at the company or industry level, if the price has appreciated or if a more attractive opportunity emerges in the same sector. Our current turnover in the portfolio is just under 25%.

What challenges are you facing today?
We are facing two main challenges in the current markets. The first being the market's ongoing "flip-flop" between "fear" (i.e. buy gold and utilities, sell financials, energy and everything else) and "recovery" (i.e. sell gold and utilities, buy financials and energy). While a number of false starts are possible, when investor sentiment finally turns, we believe the recovery could occur rather quickly. As we believe market timing to be futile, we are positioned for a recovery, as many companies that will benefit in a recovery are available at compelling valuations. The challenge remains in managing the trade-off between longer term potential and short term uncertainty.

A second challenge to manage through is when undervalued companies, with decent overall capital structures and competitive positions are forced into transactions that are detrimental to long term value creation, in order to secure debt refinancing. This, in some cases, is forcing management to take action that they wouldn't in the normal course of operating their businesses, and thereby impacting longer term value.

How is your portfolio positioned and where do you see investment opportunities?
The portfolio is currently positioned as follows:

- Overweight Energy sector - with a preference for the producers vs. the pipelines companies
- Underweight Materials sector - prefer fertilizer companies versus the gold companies
- Index weight Industrials sector - with a preference for the rail companies
- Index weight Consumer Discretionary sector
- Underweight Consumer Staples sector
- Overweight Financials sector - prefer banks versus insurance companies
- Overweight Telecommunication Services sector - prefer Rogers and Telus
- Zero weight Health Care, Information Technology & Utilities sectors

In the Materials sector, we prefer investing in fertilizer companies versus gold companies. We don't necessarily dislike gold as a standalone commodity, but when gold stocks are priced at two times net asset value, we do not feel this pricing makes sense. We have been underweight gold securities, so when the market sells off and there is a flight-to-safety, we have been slightly underperforming the market. However, when the market rallies back and the gold and safety trades are unwound, we tend to perform better.

We continue to see opportunities in a number of mid cap names that have been "beaten-up" in the sell-off. A few of these names include:

Sherritt International - Declining commodity prices coupled with political instability in Madagascar and increased construction costs at their new Ambatovy mine have weighed on the stock. However, with several business lines in two sectors (power generation & commodities), they have a diversified earnings base and strong longer term earning potential that we believe more than compensates for some of their location and business risk.

Russel Metals - While the steel industry is operating at 50% of capacity, Russell is well positioned for a recovery trading at a price to book value of 80% with low debt levels (18% debt to total capitalization) and a strong working capital position. They have three operating segments: a metal service centre business (Canada & U.S.), a second unit that imports steel from offshore, and a third unit that sells into the oil patch.

Given that we started managing the Pinnacle Canadian Value Equity Fund on February 6th, 2009, there has not been a lot of trade activity. We did sell some of our exposure in Petro-Canada as the stock rallied on the announced merger with Suncor, but bought some back after the initial excitement and once the stock had retreated. One name we recently purchased in the Fund was:

Gildan Activewear Inc. - Gildan is a vertically-integrated manufacturer of basic, low-fashion garments. They are the leading supplier of activewear for the screen print market in Canada and the U.S. (+50% market share) and continue to grow international business in Europe, Mexico and Asia. Although competition is intense, Gildan has a distinct advantage in cost and time to market - about 90% of their production is manufactured in low-cost countries (Honduras and the Dominican Republic with "free-trade" zone tax treaties) located close to their largest end-market, the U.S. (lead times of weeks versus months for manufacturing in China). Gildan's stock was beaten up in the last year - falling 75% from its high due to fears of recession and increased credit risk from one of its wholesale customers. However, we believe that with low debt levels, their earnings have the ability to get back to historic levels of 20% return on equity.

What is your overall outlook for the Canadian marketplace?
While the market has made solid gains in March and to date in April, we believe the near term outlook remains uncertain, with a slowing economy - one that is not going to get better in the short term - pitted against compelling valuations for anyone who can look past the next 2-3 years.

We have never tried to time market bottoms, as we believe markets move too quickly and erratically for this approach to work with any degree of consistency. Our approach remains unchanged; we will buy good companies at discounts to what we view as their long term intrinsic value. This means that we will hold good companies even if the near term prospects are uncertain or less than ideal. Consequently, we are currently positioned for a recovery, not because we view it as imminent, but because valuations are compelling.

To find out more about Scheer Rowlett's investment philosophy and process, please contact us.

The Pinnacle Program™ is an asset allocation service that consists of the Pinnacle Program Funds. Commissions, trailing commissions, management fees and expenses may be associated with mutual fund investments and the use of an asset allocation service. Please read the Pinnacle Program Funds prospectus before investing. Mutual funds are not guaranteed or insured, their values change frequently and past performance may not be repeated.

ScotiaMcLeod™