McLean Budden

Canadian Balanced Conservative Portfolio
Fourth Quarter, 2008

Overview
The U.S. recession and financial crisis continued to spread globally and earlier talk of 'global de-coupling' has been replaced by the reality of a synchronized global downturn. The major economies outside of North America—Europe, U.K., Japan—are in recession, the export-dependent emerging economies in Asia and Latin America (including China) have slowed sharply, while the commodity-dependent economies, such as Russia, are in crisis. Global stock markets staged a significant, broad-based, retreat in the fourth quarter with financials leading the decline. Continuing concerns about the deteriorating credit environment were exacerbated by free-falling commodity prices and weak economic results. Only the traditionally defensive sectors (telecommunication services, utilities and health care) fared relatively well in this environment.

Performance
The portfolio significantly outperformed its benchmark for the quarter as the global equity market rout continued. The key contribution came from equities where stock selection and, to a lesser extent, sector allocation were both favourable. Also adding value were the bond component and asset mix, which benefited from a relative overweight in bonds and underweight in Canadian equities.

Transactions
The portfolio initiated a position in MDS, a defensive stock trading at a compelling valuation. The company operates three core businesses – Analytical Technologies, Nordion and Pharma Services – comprising analytical instruments, molecular imaging, and pharmaceutical contract research, respectively. A sum-of-the-parts valuation approach currently ascribes no value to the company's pharma services division, thereby enhancing its attractiveness.

Outlook
Recession realities were front and centre in the fourth quarter, with confirmation that a U.S. economic contraction began in December 2007. Not even the 56% plunge in oil prices in Q4 was enough to keep economic growth from likely suffering its worst quarterly performance since 1982. The U.S. economy is dealing with more than just a deep recession, as money and debt markets remain stressed and housing prices continued to fall. Banks and households have been de-leveraging, further undermining asset values, which is highly deflationary. In response, there have been unprecedented fiscal and monetary policy actions, culminating in the U.S. Federal Reserve cutting the Fed Funds rate to a range of 0%-0.25% in addition to using unconventional measures of monetary policy. In Canada, a recession likely began in the summer, and the Bank of Canada cut rates to 1.5% from 3% in Q4, after being on hold for much of Q2 and Q3. The Conservative government has committed to ease fiscal policy, but a political turmoil has delayed fiscal action until a new budget is tabled. In this environment, stocks are faced with offsetting fundamentals of excellent valuations—especially relative to bonds and cash—but downside earnings risks remain high. Government bond yields should remain low as deflation risks outweigh inflation, short rates remain low and recessionary conditions persist, while corporate bonds offer excellent value.