

DYNAMIC CANADIAN VALUE FUNDS

THIRD QUARTER 2011 COMMENTARY

The markets

The breadth and speed of this correction caught me off guard. Attempting to manage funds in a rational manner when all else around you is irrational is an extremely frustrating exercise. While global economies have certainly slowed after the strong snap back from the 2008-2009 recession, fundamentals today look nothing like those of two years ago. With the last correction still on investors' minds and the pain and suffering it caused, it's not surprising that investors are selling first and asking questions later. Equity markets seem to be following a path similar to that in mid-2008, while bond market performance has dwarfed that experienced three years ago. The S&P/TSX Composite is down some 20% in the past three months and is underperforming government bonds by 25%, making it the fourth worst period of relative performance since 1979. In fact, there have only been six such events of this magnitude on record.

The recession of 2008-2009 was a function of seven years of cheap debt and ultimately an incentive to leverage. Since then, consumers have either defaulted or significantly reduced debt and increased savings. This time around we do not have the same excesses and bloating at the consumer or corporate level. The issuance of residential mortgage loans in the past three years has been almost nonexistent. Saving rates are back to normal levels and corporations are sitting on record levels of cash. While economic results in North America and emerging markets have been relatively strong, investors are ignoring all data given the universal concern that economic woes in Europe will cause a contagion and infect the rest of the world either through a decline in exports or a banking sector meltdown. Without immediate actions from the ECB and EU, this scenario could become reality.

In a recent report, Scotia Capital compared the normalized performance of US government and corporate bonds with equities for the TSX Composite and S&P 500 during the 2008/2009 slowdown period and since the May 2011 S&P 500 peak. They also looked at corporate profits, ISM, jobless claims and leading economic

indicator patterns. They found that bond markets seemed to be pricing in a recession similar to 2008, as the normalized credit spreads have been widening in a pattern similar to 2008. However, currently, S&P 500 earnings are significantly stronger than those experienced in the past recession. In addition, ISM data, jobless claims and leading economic indicators are much better this time around. Yesterday as markets continued their plummet, it was reported that North American auto sales for the month of September beat expectations and were up versus August levels. In other words, equity markets are retracing the 2008/2009 experience even though the fundamentals don't warrant it.

Valuations are approaching "lifetime" lows and many high quality companies are available at compelling valuations. Many are trading below March 2009 levels even though profitability is up and debt levels are down. Many are also paying higher dividends as a result of cleaner balance sheets. When fear and capitulation wane, these companies will likely continue their historical track record of outperformance.

Commodity prices have rolled over and have yet to find a bottom. Due to rising costs of production, previous bottoms have all been set at subsequently higher prices. In other words, each successive low has been higher than the last. Copper, coal, and oil prices in March 2009 never reached levels seen in the preceding recession. We believe the same will occur this time around, even if we do go into recession. The producers owned in our funds are all low cost operators that we expect will be the last ones standing and still profitable at the bottom. We've stress tested every producer at significantly lower commodity prices and are convinced of their financial strength and earnings power.

The funds: performance and positioning

Fund performance year to date has been disappointing. There were a number of contributing factors to this underperformance. Many stocks in the portfolio had strong gains in 2010 – we took profits on a few, however we held on to a number of these quality companies because of their strong fundamentals and attractive valuations. Last year's big wins such as Hudbay and Magna have been severely punished as a result of the indiscriminate selling, despite their fundamentals.

Our Canadian Value funds are managed to protect capital and deliver growth over the long term. With that objective, we focus our efforts on investing in high quality companies such as those mentioned above. Indeed, neither buying companies with clean balance sheets that are strong dividend payers, nor owning stocks trading below market multiples have helped in the short term; however, we can't get caught up in the fear and panic, and sell fundamentally strong, high quality businesses at absurd lows.

Underperformance among a few US names also detracted from fund performance relative to the S&P/TSX Composite Index. We sold some positions, such as Bank of America, that we didn't expect to deliver on earlier projections; however, they still had a negative impact on year-to-date performance. We have taken advantage of valuations and added to the funds' positions in other names we are still very positive on, such as Arch Coal and Freeport-McMoran Copper.

The funds have a significant overweighting in precious metals, which historically has provided a hedge against economic uncertainty. Unfortunately this current market rout has spared few. We have now entered a period once again where over-invested individuals and investment funds must raise additional capital and, as a result, are forced to sell anything with a bid. We experienced this behaviour in early 2009 and we are confident that such indiscriminate selling usually marks the bottom. We don't expect this time to be any different.

We buy companies at a discount to their intrinsic value. The best value opportunities often emerge when there is fear and capitulation in the market, and there is extraordinary upside. History has shown that the more a stock falls, the more likely it is to rise in the future. It is far less risky to buy a stock that is falling than one that is rising. In the short term, however, when fear grips investors, buying stocks is akin to catching falling knives. Investing based on short-term performance is risky. Buying with a long-term vision is always prudent. With this in mind, we have been buying. Late in 2008 and early 2009 we made significant changes to the portfolios to position them for when the bottom was set and the market turned, and we came back strong. We are doing the same during this meltdown. While the effects of these changes are not being reflected in the short-term, they will be in the long-term.

We have reduced our small/mid-cap names and have replaced them with large-cap names. Large-cap names have seen their prices decline significantly and we are now in a position to add liquidity without paying a premium.

We have taken advantage of the past two months to continue high-grading the portfolio. We are thinking long-term as it is irrational and difficult to make short-term calls. We are continually looking for companies with compelling valuations, catalysts for growth and better risk/return profiles than the bottom few companies in our portfolios.

Gold is in the portfolio for defensive purposes as gold stocks generally hold up when markets get hit hard. Most gold stocks are trailing the commodity. However, the gap is narrowing and we expect some strong quarters ahead given that operating costs have stopped rising at the same pace as the price of gold. Currently, gold accounts for about 20% of the equity funds and 12% of the dividend funds. This exposure should act as a hedge if markets continue to deteriorate.

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We do have cash in the portfolios (up to 10% depending on the mandate). However, as a value manager, it is difficult to stockpile cash when you are faced with extraordinarily low valuations. Many of the companies we own are net debt free, have great asset bases, pristine balance sheets, pay dividends and survived through 2008. While it is impossible to predict the bottom, all of these companies will surely exist, and most likely prosper, once we reach the other side.

It is extremely frustrating to make investment decisions based on sound research and fundamentals when the market isn't, but we can't deviate from our strategy. Although the funds have underperformed during this market meltdown, the Canadian Value portfolios are the highest quality we have ever managed. When we return to a normalized market, we believe that fund performance will reflect the positive changes made in the portfolios. We've been through this before – and yes, it hurts – but I am certain we will get through this current correction. We don't know when but, at some point, indiscriminate selling will revert to indiscriminate buying. The same investors who are tripping over themselves to get out of the market will be elbowing one and other to get back in. Guaranteed.

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