FORTRESS Global Bond Fund (Laketon) — Investment Review

Fund Highlights

Second Quarter 2009

Market review:

- The second quarter will go down in the record books as the quarter delivering the biggest outperformance by corporate bonds versus government bonds for as long as decent records have been kept.
- In Canada, the DEX Universe All Corporate Index returned 6.5% versus -1.8% for the DEX Universe Canada Index, while in the U.S., the Merrill Lynch Index corporate component returned 10.8% versus -3.1% for the Treasury component.
- Finally in Q2, investors backed away from the fear (or Armageddon) trade, opening the door for corporate bond (and equity) buying, causing yield spreads to narrow in the process.
- As a result of more risk tolerance from investors and more issuance by governments, global government returns were a poor -0.57% during the quarter with the poorest performers being the U.S. and Australia at –3.1% and -3.8% respectively in local currency returns, all according to the Merrill Lynch Global Bond Index. Canada was the next worst performer at -2.3% in Canadian dollars.
- Sovereign issuance continued at break-neck pace in response to ballooning government financing requirements on the back of expansionary fiscal policy and clearly put pressure on government yields. At the current pace, government bond issuance for 2009 is estimated to be $5.3 trillion with the U.S. being responsible for around $3 trillion according to Hayman Advisors LLP.
- The dollar markets were also affected by improving consumer confidence and the emergence of expectations, by some, that tighter monetary policy would indeed not be that far off – and necessary to ward of higher inflation.
- The Euro bond markets performed relatively better, returning 0.63% in local currency terms for the quarter as signs of economic recovery appeared to be further off.
- In terms of currency performance, it was another difficult quarter for the U.S. dollar, albeit with some positive benefits to the U.S. balance of payments. Of note, the Pound, Aussie and Canadian dollars appreciated by 14.7%, 15.7% and 8.1% respectively against the U.S. dollar during the quarter.

Portfolio review

Positive performance factors in the second quarter

- Over the quarter, the Canadian and Australian dollars appreciated 8.5% and 16.5%, respectively. The funds substantial over weight in these two currencies contributed positively to performance.

Negative performance factors in the second quarter

- Government bond yields in most major markets rose significantly over the quarter as the talk of economic "green shoots" brought out an appetite for riskier assets. Over the quarter, 10-year U.S. Treasury yields rose by 87 basis points, while similar term Canadian and U.K. government bonds rose by 58 basis points and 52 basis points, respectively. The fund's long duration in these sectors had a negative impact on performance for the quarter.
- The fund's overweight in the greenback against and underweight in yen hampered performance as the yen appreciated almost 3% against the U.S. dollar. Note that the DXY (the U.S. dollar versus a trade weighted basket of currencies) lost over 5% of its value during the second quarter.

Outlook and Strategy:

- We expect the bond market to take a breather in the third quarter. In Q2, government yields rose in concert with the fall in corporate yield spreads. In both cases, we feel the market has got ahead of itself and we would expect to see some correction.
- We don't expect the fear trade to re-enter the psychology of investors, however, we do expect investors to be more fearful of a disappointing recovery from recession.
- Volatility should continue, especially given the reduction in market liquidity.
- There has been a lot of corporate issuance recently. We don't expect the pace to continue into the next quarter. There was clearly a backlog of supply, and issuers took advantage of the narrowing yield spreads and investor excitement. We don't feel this demand for capital will follow through over the balance of the year.
- The U.S. government market, which had been the weakest government market performer during the second quarter, should see some relative improvement in the third quarter. We expect inflation fears of investors, especially in the U.S., to dissipate for the time being.
- We should also see some flattening of yield curves as investors become a little more comfortable with lower yields over the medium term.
- The U.S. dollar is likely to remain under pressure under the burden of a continual barrage of new Treasury issuance. We will look for an opportunity to reduce the portfolios exposure to the U.S. dollar.
- We expect the commodity currencies to be volatile and to benefit from some improvement in commodity prices.

Any amount that is allocated to a segregated fund is invested at the risk of the contractholder and may increase or decrease in value.

This report is published to provide additional information on economic conditions and investment performance. It was prepared by the fund manager, Laketon Investment Management.