FORTRESS Money Market Fund

Fund Highlights

Investment Review

Second Quarter 2009

Market review:

- In Canada the DEX 90-day Commercial Paper Index returned 0.34% versus 0.12% for the DEX 91-day T-Bill.
- 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.
- Issuers responded with a flood of new issuance, relieving the financing backlog that was building since Q4 of last year. In all, the Canadian and U.S. markets saw $18 billion and $396 billion of new corporate issues in the second quarter, respectively.
- The Bank of Canada announced they intend to keep rates at or below 25 basis points for the next year. However, they have given a caveat that rates will only remain low if core-inflation remains within the bank's comfort zone.
- Perhaps the best illustration of how the flight to safety in the bond market has eased is to look at the liquidity premium experience by Canada Mortgage Bonds ("CMBs"). CMBs are issued by Canada Housing Trust -- a vehicle set up by the CMHC and fully guaranteed by the Government of Canada. The credit crisis caused 5-year CMB yields spread over Canadas to widen from 12 basis points in March of 2007, to 60 basis points at the end of December 2008 and now sit at 44 basis points. Given the Federal guarantee of CMBs, the bulk of the spread widening was liquidity driven – a direct result of a flight to safety.
- Investors have continued to be more comfortable with short term risk and consequently have chased higher yielding products such as commercial paper ("CP") and banker's acceptances ("BAs"). Demand for credit has driven spreads significantly tighter over the first and second quarters. In the past 6 months, CP and BAs have tightened 166 and 96 basis points respectively.
- The commercial paper market has also benefitted from a new found interest amongst equity managers, private equity and hedge funds, and retail investors amongst others, who have all been looking for higher returns. This new level of interest suggests to us that the movements in the commercial paper market may not be as reliable a barometer of traditional fixed income investor sentiment as in the past.
- In addition, the reduced allocation of capital by banks to their fixed income trading operations has also resulted in a greater volatility of bond prices.
- Many commentators and the media, in particular, have suggested that the rise in yields was mostly in response to investor fears of inflation on the back of extremely easy monetary policy.
- We contend that most of the rise in yields relates to the supply demand imbalances emanating from the gargantuan treasury issuance schedule, the uneven participation of domestic and foreign buyers and the unpredictable intervention of the Fed.

Portfolio review:

Positive performance factors in the second quarter

- An overweight in 6-month T-Bills contributed positively to performance, outperforming 91-day T-Bills by 9 basis points.
- The fund's exposure to Canadian Mortgage-backed Bonds (CMBs) also added to performance as these securities outperformed Government T-Bills.

Negative performance factors in the second quarter

- The fund had no exposure to CP or BAs which, on average, outperformed T-Bills by 20 basis points.

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 gotten 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.
- We will look for opportunities to lengthen the duration of the portfolio – our bias is for yields to trend lower. However, we will put the qualifier that further government intervention has the capacity to derail any rally in yields.
- There has been a lot of corporate issuance recently but 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 fund does not hold any commercial paper, or credit product as at the end of the second quarter. We will continue to look for an opportunity to re-enter those markets and pick up attractive yield.

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.

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