FORTRESS Balanced Fund (Laketon) — Investment Review

Fund Highlights — Third Quarter 2010

Market review (all figures, Total Return)

- Equity markets rallied through the third quarter, with the S&P/TSX Composite Index gaining 10.3%.
- Materials (+18.2%) was the best-performing sector, followed by Utilities (+15.5%) and Consumer Staples (+15.4%).
- Information Technology (-1.7%) was the weakest sector, and the only one with a negative absolute return. The Energy (+7.0%) and Financials (+7.8%) sectors were other relative underperformers.
- Bond investors have had a roaring time over the last couple of years, and for those who thought maybe the Fed had used up their last tokens, in comes Bernanke et al (save Hoenig and some others) with a bag full – ready to be opened soon – in the form of a second round of quantitative easing.
- The market, or more correctly, bond investors are expecting a Treasury buying program, likely to be gradual in the short to middle part of the yield curve, so much so, that they have been happy to purchase treasuries and push yields lower.
- Indeed, during the third quarter, 10-year Treasury and Government of Canada yields fell by 42 and 32 basis points, to 2.51% and 2.76% respectively, edging ever closer to the recent lows of 2.06% in the U.S. (at Dec. 30, 2008)) and 2.56% in Canada (at Jan. 14, 2009).
- The Canadian bond market returned a stellar 3.15% for the quarter (according to the DEX Universe Index), especially impressive given that the overall yield to maturity averaged only 3.04% during the quarter.
- Canadian corporate bond market returns were only average, returning 3.16% for the quarter (according to the DEX Universe Index), despite having an average yield close to 1% higher than that of the government sector.
- While the Fed actions have caused the bond market to fluctuate, the volatility has been helped along by the generally poor macroeconomic data coming from pretty much everywhere. G7 economies have been slowing and even dependable China has become lacklustre. (Although we would never rule out the capacity of China to turn on a dime.)
- The Bank of Canada raised rates one more time to 1%, but as we previously mentioned it might do, has used its self-declared retrospection to signal that it would likely not move again this year.
- With interest rates on hold at low levels in most of the developed world, equities and corporate bond markets have managed to remain steady, despite questionableeconomic prospects.
- Corporate bond issuers have taken advantage of this agreeable situation.

Portfolio review

Positive performance factors in the third quarter

Asset Mix

- A continued under weight cash position added about 17 basis points to performance.

Security Selection

- Stock selection within the international portion of the portfolio added modestly to performance.

Negative performance factors in the third quarter

Asset Mix

- A modest over weight to fixed income detracted slightly from performance.

Security Selection

- Being void Potash hurt the stock selection within the Canadian Equity portion.

Outlook and strategy

- With all the macroeconomic challenges, the outlook for the next quarter and beyond is hazy at best. The following are a few of the major issues that could have a significant impact on the direction of markets:
  - a currency trade war and inherent protectionist policies that are likely to result from them;
  - low absolute levels of interest rates and the implied inflation/deflation outlook (…never mind the significant hit to pensions and savings); and,
  - Washington versus Corporate America and the increasing amount of re-regulation.
- Recently, markets have begun to rally on the back of additional unconventional monetary policy measures that the U.S. central bank is expected to employ (referred to as quantitative easing or QE2). The hope is that the Fed will drive interest rates down further by bidding up bonds, which will cause related assets to

rise in value, thereby giving the household balance sheets a boost by shoring up their net worth (read: housing), so that they have the confidence to spend (read: stem the deleveraging cycle). Furthermore, lower interest rates are negative for the U.S. dollar (USD) but should help the export market. There is some fear that an excessive amount of stimulus will cause hyperinflation down the road, but with excess capacity and a high unemployment rate, the jury is still out on this one. Clearly, the "promise" of additional stimulus takes the downside risk out of the market for stocks (at least in the short term), as witnessed by the first round of quantitative easing done in early 2009. What's not clear is the timing of QE2, and with U.S. mid-term elections in early November, the Fed doesn't want to be seen influencing markets. It should be noted that QE2 carries relevance with the first two bullet points listed above; however, the first bullet is not within the Fed's mandate.

- It's difficult to believe that the QE2 backdrop will be good for price earnings multiples, however the earnings outlook (the "E") may be okay. Corporate balance sheets remain healthy, and the prospects for mergers and acquisitions, share buybacks and/or dividend increases look promising. Obviously, QE2 wouldn't be contemplated if the prospects for GDP growth weren't expected to slow in the near term and hence there's a high probability that the outlook for earnings revisions are negative. From a sector perspective, a weaker USD is positive for commodities, and we retain a positive bias toward the Materials, Energy and Industrial sectors. Golds should continue to perform well if the USD is weak and European interest rates don't rise. Within the Financials, we have a negative bias toward the insurers, given the low rate environment and a slightly positive view of the banks with their balance sheet strength and reasonable valuations. Lastly, taking the consumer sectors in total, we remain under weight the Consumer sectors until we have increasing confidence in the prospects for employment growth. From a stock selection perspective, we continue to over weight stocks that have positive earnings growth and momentum prospects, are leaders within their industry, and/or have pricing power. Stocks that reflect this positive view are Baytex Energy Trust, Silver Wheaton Corp. and Finning International Inc.
- There seems to be little doubt among market participants that the Bank of Canada will refrain from raising rates further this year, after having raised the overnight rate to 1% on September 8th. The weaker economic data in both Canada and the U.S. has created a backdrop for the Bank to put monetary policy on hold. We also note the certainty with which the Fed has indicated that overnight rates in the U.S. will not rise any time soon.
- QE2 has become the TLA (three letter acronym) of choice, as members of the Fed have communicated their receptivity to further monetary stimulus through quantitative easing. We are sceptical of QE's ability to deliver more stimulus via both consumer or commercial channels and believe that the Fed will likely resort to QE only in the event that they feel capital markets need more propping up or there appears to be impasse on the fiscal front.
- As we are still in mid-term election season in the U.S., we don't expect much progress on any sort of fiscal stimulus; but we do expect the Obama administration to take up the gauntlet afterward.
- The concentration in 10-year bonds, has given the portfolio more running yield, reasonable positioning in the recent flattening, and good performance in the summer rally. We expect the 10-year part of the yield curve to stay out of trouble, and hence we will retain the portfolio's overweight in that part of the yield curve.
- The recent underperformance of corporate bonds had presented an opportunity to increase the portfolio's running yield at attractive yield spreads. We began increasing the corporate weight during the quarter and it is now largely completed; we would look at any further yield spread deterioration as an opportunity to increase our exposure further. Despite there being many areas of economic uncertainty, our expectation for policy support – both fiscally and monetarily should keep yield spreads well supported.
- Although we are not immediately concerned about the North American sovereign debt situation, we have noted that the situation in the U.S. is something to be watched. However, we believe that the trouble with European sovereign debt will likely provide a longer window for the U.S. to address its issues.

Any amount that is allocated to a segregated fund is invested at the risk of the contract holder 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 Laketon Investment Management.

FaithLife FINANCIAL