

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.

Portfolio review

Positive performance factors in the third quarter

By Sector:

- Our overweight position in the outperforming Industrials sector was a small positive driver.
- Our underweight positions in the underperforming Information Technology and Energy sectors also added slightly to performance.

By Stock:

- Stock selection had the greatest positive contribution within the Industrials, Telecommunication Services and Energy sectors.
- Individual holdings that added the most to relative performance this quarter include: Eastern Platinum Ltd. (+46%), Finning International Inc. (+36%), Teck Resources Ltd. (+34%), SNC-Lavalin Group Inc. (+23%), Brookfield Asset Management Inc. (+21%), Baytex Energy Trust (+17%) and Red Back Mining Inc. (+15% to sale).
- Another positive factor was not having exposure to certain underperforming index names, including Goldcorp Inc. (-4%), Encana Corp. (-10% while not held; +7% from purchase on 8/20/10 to end of quarter) and Sun Life Financial Inc. (-4%).

Negative performance factors in the third quarter

By Sector:

- Our underweight positions in the outperforming Consumer Staples, Utilities and Materials sectors, all detracted from performance to a limited degree.

By Stock:

- Stock selection within the Materials and Consumer Discretionary sectors had the most significant negative effect on performance.
- Individual holdings that hurt performance on a relative basis include: Canadian Oil Sands Trust (-6% to sale), Gildan Activewear Inc. (-5%), IAMGOLD Corp. (-3%), Barrick Gold Corp. (-2%), Canadian Natural Resources Ltd. (+1%) and Bank of Montreal (+3%).
- Not holding certain outperforming index names through the period also have a negative influence on performance, including: Ivanhoe Mines Ltd. (+75%), Potash Corp. (+62% while not held; -1% from purchase on August 17, 2010 on news of proposed takeover by BHP Billiton Ltd. to end of quarter), and Agrium Inc. (+48%).
- Our cash position, at an average weight of 4.7%, was another detrimental factor in a strong market.

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. This 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-to-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 sector, 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, given their balance sheet strength and reasonable valuations. Lastly, taking the consumer sectors in total, we remain underweight the consumer until we have increasing confidence in the prospects for employment growth. From a stock selection perspective, we continue to overweight 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.

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.