FORTRESS Money Market Fund

Investment Review

Fund Highlights

Third Quarter 2009

Market review

- For those who "believe", the third quarter is proving to be the turning point for the global economy – from recession to recovery.
- For those "non-believers", the third quarter is a demonstration of the power of government intervention and is no more than the nexus between a V and a second V -- ie. the midpoint of a W.
- Nevertheless, the quarter did demonstrate the power of the U.S. government as "Cash for Clunkers" and "Hope for Homeowners" managed to generate benefits for the auto and housing sectors respectively.
- U.S. auto sales rebounded from a monthly average in Q2 total of 9.64 to 11.51 million in Q3 (annualized). At the same time, the pipeline of unsold homes declined from 3.8 to 3.62 million over the quarter.
- While the U.S. was clearly one of the worst and first hit economies, the conventional wisdom held that it would also be the first to recover. However, early signs are that more robust recovery is emanating from emerging economies (Q3 GDP at 1.7% year-over-year, according to IMF forecasts) compared with advance economies (Q3 GDP at -3.4% year-over-year, according to IMF forecasts).
- On the other hand, non-U.S. dollar-block economies, particularly commodity-rich Australia and Canada are showing signs of a more robust recovery, particularly in terms of industrial production and commodity exports.
- Unfortunately for Canada, the precipitous decline of the U.S. dollar against all currencies, and more importantly the Canadian dollar -8.7% over the quarter, has meant that net exports of goods and services to the U.S. have suffered.
- Corporate treasury desks continued to avoid commercial credits in favour of short dated Treasury bills. The obvious trade has been to sell short dated bills on days when treasurers have been investing funds in high quality government securities.
- During the past 6 months, investors and brokers have been willing to loosen their purse strings, and we have seen liquidity return to sectors once as dry as the Nevada desert. A clear indication of the return of liquidity has been the Bank of Canada's removal of two liquidity programs – the Term PRA Facility for Private Sector Instruments and the Term Loan Facility, as well as the reduction of the Term PRA Facility to bi-weekly from weekly.
- In terms of monetary policy, central bankers have begun preparing investors for policy reversal. For example, Bank of Canada Governor Mark Carney said in a speech in September: "Policy-makers will have to act deftly to maintain stimulus long enough for private demand to take up the burden of growth, but not too long to undermine confidence in and the sustainability of that growth."

Portfolio review

Positive performance factors in the third quarter

- The fund's exposure to higher yielding bankers' acceptances (BAs), provincial bills and bonds was increased given that the yield on Treasury bills with less than 30 days to maturity had fallen to around 10 basis points. This shift increased the running yield in the portfolio by 4 basis points and contributed positively to performance as spreads between higher yielding products narrowed following the trade.
- The fund's exposure to Canadian Mortgage-Backed (CMB) securities also added to performance as CMBs outperformed Government T-Bills as CMB-T-Bill spreads narrowed by 9 basis points with CMB yields even trading through (or were more expensive than) similar term Government T-bill yields.
- The money market yield curve, which has not been as volatile as the short Government bond yield curve, did flatten (longer yields fell relative to short term yields) by 4 basis points during the quarter. The fund's average term-to-maturity was kept constant at 90 days, but the fund was over-weighted in the wings (1-2 month and 5-8 month securities) leading to an out performance of 4 basis points over 91-day T-bills.

Negative performance factors in the third quarter

- The fund had no exposure to commercial paper (CP) which outperformed Treasury Bills by 5 basis points during the quarter.

Outlook & Strategy

- The global economy is recovering at various speeds, with the best prospects coming from emerging Asia – namely China and India. There is a certain amount of inertia that is inherent in the emergence of these economies that should be sustainable.
- The developed world is more of a question mark. Commodity driven economies will benefit from emerging economy growth – Canada and Australia should do fairly well. We are less optimistic for the rest of the developed world.

- The U.S. economy is still very much a work-in-progress. The letter W has its origins in the letter V (7th Century Old English), and so too will the U.S. W-shaped economic pattern have its origins in the V-shaped economic rebound of late. In our opinion, too much of the strength of the recovery has been closely tied to government intervention – a factor that we don't believe is sustainable.
- We don't expect to fall into a technical recession of anywhere near the magnitude of the one we've just been in, but the economy is set for a setback.
- The fortunes of the bond market are, however, more complicated than just the prospects for the economy. We expect substantial government supply to continue – the 2010 forecast for the U.S. and Canada is $2,300 billion and CAD $85 billion respectively over the next year. We are not as certain about demand.
- Government bond demand can be divided between domestic and foreign sources. In terms of domestic demand, we expect it to continue as consumers, particularly American, continue to save and these savings eventually make their way to the government bond market. In terms of foreign demand, the picture is less clear – currency will be a factor and could cause funds to be diverted away from U.S. Treasuries.
- Nevertheless, we still expect yields to stay low, and any rise in yields will present a buying opportunity. Volatility should remain low.
- At the beginning of the year, we were confident that we would not see any interest rate increases in North America until at least 2010. We are comfortable taking the Fed and the Bank of Canada at their words with both indicating short term rates will be kept at historically low levels well into 2010.
- We also feel the Bank of Canada will not want to further exacerbate the impact of Canadian dollar appreciation by tightening monetary policy despite the relative resiliency of the Canadian economy in the face of ongoing hits to the manufacturing sector via the stronger dollar.
- Demand for corporate paper is substantial, although we are less certain that it has staying power. Demand is made up of far more opportunistic investors, who will likely make a quick exit the moment returns reverse.
- In the CP and BA markets, we will remain opportunistic and look to make relative value trades between sectors and issuers.

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.

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