FORTRESS Money Market Fund

Investment Review

Fund Highlights

Third Quarter 2010

Market review

- 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.
- 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 two more times 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. Post the policy announcement, expectations of future rate hikes ebbed on the back of weak U.S. economic data and prospects of further quantitative easing. At quarter end, the market was pricing in only a 15% chance of a 25 basis point hike at the Bank of Canada's next three scheduled meetings.
- As a result of the rate hikes and lowered rate hike expectations going forward, the yield differential between one-month and three-month bills narrowed from 20 basis points at the end of June, to three basis points at quarter end. By the end of the quarter, one, two and three-month bills moved from yielding 32, 42 and 52 basis points respectively, to 84, 86 and 87 basis points respectively.
- The commercial paper market in Canada decreased slightly ($0.8 billion), through the summer to $28 billion, whereas the provincial, municipal and agencies market fell by a greater $5.5 billion, to $39 billion. The decrease in outstanding balances was largely seasonally driven.

Portfolio review

Positive performance factors in the third quarter

- The fund maintained a significant overweight in provincial T-bills (22%) and BA notes (20%) throughout the quarter. Three-month provincial T-bill and BA spreads widened marginally (1 and 5 basis points respectively), but this widening was more than offset by the incremental yield pickup of 12 and 31 basis points respectively that these securities provided over Canada T-bills.

Negative performance factors in the third quarter

- Our view that the Bank's shortening projection horizon would create more policy uncertainty over the medium- term (and consequently more volatile short-term rates), led us to maintain the portfolio's average term to maturity at approximately 60 days. For the quarter, one, two and three month bills returned 9, 11, and 14 basis points respectively.

Outlook and strategy

- 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.
- 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 an 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.
- 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.
- The recent widening in provincial and BA notes has presented an opportunity to increase the portfolio's running yield, at attractive yield spreads. We have begun this process and will continue to look for further opportunities.
- We will continue to remain opportunistic in the commercial paper market.

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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