

## Canso Corporate Value High Yield Bond

**Canso Investment Counsel Ltd.**



The financial markets continued their strong run into the third quarter. Paltry yields on government securities prompted investors to flock to higher yielding corporate bonds and risky equities. Even as the liquidity flood gates opened for banks and quality corporates, several weaker entities continued to encounter financial problems. Similar stress is also being faced by consumers with a high debt burdens and rising unemployment. The recent 'Cash for Clunkers' deal in the U.S. and similar fiscal stimulus programs may yet prove to be temporary additions to economic growth. We believe that the economy will remain weak until employment rates improve and consumer demand replaces government spending. The strength of the Asian economies should assist in reviving GDP growth rates in the developed world. We expect stimulative monetary policy to continue for some time as central bankers want to be sure of economic recovery before they return to a neutral stance.

Corporate yield spreads (excess yield over government bonds) continued to grind lower during the quarter. Companies took advantage of the absolute low yields to lock in cheap financing. The U.S. bond market was up 4.2% during the quarter but was completely overshadowed by corporate bonds which were up 8.3%. The Canadian corporate bond index rose 4.5% compared to the overall bond market at 2.7%. We expect default rates to continue to rise as weaker companies are challenged by poor demand and liquidity pressures. The refinancing of leveraged buyouts from the credit boom may prove difficult. The near universal consensus that the immense monetary stimulus of the past year should contribute to higher inflation in the longer term is hard to argue with. The most powerful argument against it is that it is the consensus. This makes us more than a little nervous. True, more dollars usually mean more inflation. This could take much longer than most forecasters now believe. The excess slack in the economy and increase in consumer savings rate should keep inflation at bay for at least the next six to twelve months. We expect that the Canadian economy will be impacted by decline in consumer spending and strengthening Canadian dollar. A stronger dollar improves the Canadian inflation picture but will devastate manufacturing exports to the U.S.

The DEX Corporate Index returned 4.5% for the quarter which was 1.8% ahead of the DEX Universe Index and 3.3% ahead of the Canada Index. Corporate bond

yield spreads continued to narrow in the quarter as investor fear subsided. A-rated issues outperformed the index by 0.7% as financial bonds rallied significantly and BBB-rated issues also outperformed by 0.7% due to spread narrowing. For the 12 month period the Corporate Index outperformed the Universe Index by 4.5% and the Canada Index by a strong 6%. BBB-rated issues had the strongest performance at 16.1% followed by A-rated issues at 14.9% due to the strong rally in financial issues, particularly Tier 1 Capital securities.

Portfolio performance ranged from 7.3% to 8.5% for the quarter ending September 30th. These results compared favorably to the DEX Corporate Index return of 4.5%. U.S. financial issues as well as the Royal Bank of Scotland (RBS) positions rallied in the period. Additionally, the distressed positions in Clearwater Seafoods, SFK Pulp Fund, Nortel and GMAC Canada appreciated significantly. The portfolios are comfortably ahead of the benchmark since inception with value added ranging from 4.9% to 5.4%.

Our moderate outlook is in stark contrast to our critique of the securitization mania prior to the credit debacle. The first signs of speculation are afoot, but nothing that augers the downside of the credit implosion we have just been through. We don't see major problems in either the markets or the economy prior to the withdrawal of the stimulus programs. As bottom up credit foot soldiers, we've just been through a major battle in an ongoing campaign. It's not up to us to look at the macroeconomic big picture, we leave that to the economists and interest rate anticipators well behind the lines at headquarters. We are still buying cheap bonds. "Ours is not to reason why, ours is but to do and die".

## Bissett REITs

**Leslie Lundquist, CFA**

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*Franklin Templeton Investments*



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Global real estate markets produced strong returns during the third quarter, as investors became more convinced that previously feared economic disaster scenarios had been averted by the actions of central banks around the world, and as many real estate entities were able to access debt and equity markets to remain solvent and, in some cases, strengthen their balance sheets. The Canadian REIT market partici-





pated in this global recovery, and produced strongly positive returns that outpaced the Canadian stock and bond markets by a wide margin.

Similar to last quarter, the greatest gains in the REIT space were made by the smaller and more aggressive REITs. In this environment, the ATB Compass Portfolios enjoyed strong returns, but did not entirely keep up with the market. We did not make any changes to the model portfolio during the quarter. Therefore, the September 30 model portfolio target weights were unchanged from the June 30 target weights. The portfolios were invested substantially in line with these target model weights at the end of the third quarter. None of the ATB Compass Portfolio's REITs increased or decreased their distributions during the third quarter. We continue to believe that most Canadian REITs will focus on maintaining their present distribution levels and will use any excess cash flows to reduce debt levels and improve corporate liquidity for the foreseeable future.

Although we are pleased with the strong returns enjoyed by the Canadian REIT market and the ATB REIT portfolio this quarter, we remain cautious. Canada appears to have weathered the economic and market storms of 2008 and early 2009 very well, but we believe that REIT prices today leave little room for disappointing operating results, which could still surface in REITs' results in coming quarters. We continue to take a conservative and income-oriented approach in the ATB Compass REIT portfolios, and expect that this should allow us to participate in any further market gains while also providing a measure of support in the event of future market weakness or operating disappointments.

## Mawer Canadian Equity

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The change over the last six months has been remarkable. In a near-total reversal from the outright panic in March, conventional wisdom is now that the recession is either over or soon will be (no less an authority than Ben Bernanke even said so). As a result, the TSX Composite and the Mawer Canadian Equity Fund gained 10.6% and 8.9% respectively. While some see a V, W, L or U-shaped recovery, we predict it will look more like a square root sign. We think that the economy and capital markets will indeed bounce off recent lows but the subsequent recovery period will be more drawn out than we've become used to. While it seems clear that we're not going to fall off a cliff, it also seems likely that we're not going to be able to shrug this one

off as if nothing happened. Our view is that the current rally will probably continue for a short while, and then run into some kind of "mini-crisis," then transition into a slower, more drawn-out recovery. One trigger for the correction could simply be that it becomes apparent that de-leveraging is keeping a lid on consumption and investment, causing the recent enthusiasm in markets to dissipate. Alternatively, a signal from central banks that they will tighten monetary conditions as part of an "exit strategy" could result in a correction. Other triggers could include difficulties in the commercial real estate market or an unexpected slowdown in China. Any of these outcomes would be trying, but they would not be reason to panic or to expect a return to meltdown conditions of 2008.

In this environment, we still believe Canada will be a good place to invest. Financial services companies, which make up over one-third of the index, should perform well. Their market positions are very strong and they are in great shape to expand. Bill Downe, CEO of the Bank of Montreal, called it a "once-in-decades growth opportunity." On the other hand, while we believe that commodities such as gold, copper and oil will see good long-term demand, we think that many commodity companies will see meaningful corrections in the next 12 months. In our view, gold and copper are very risky bets and are likely to decline during this period. Oil is currently at the upper end of our expected \$50-75 range so it could also drift lower, but we think that energy companies are not pricing in aggressive commodity price assumptions so should hold their value reasonably well. In all three cases, we expect that there will be supply responses to higher commodity prices so the market will eventually question the assumption that "we're running out of everything".

Outside of these oversized areas of the TSX Composite, there are many other areas of the Canadian market to invest profitably, such as in infrastructure, pipelines, consumer staples and distributors. As a result, we believe that returns to our portfolio will be attractive over the next year, notwithstanding our concern around commodities and the potential for a brief "mini-crisis" during the period.

## Mawer New Canada

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The rally in small caps continued in the third quarter. The BMO Small Cap Index (BMO SCI) rose 21.1% while the Mawer New Canada Fund rose 18.9%. The way we see it, 2009 could be called the year of the "Lazarus



rally”, with riskier companies that were left for dead during the market crash coming back to life. As a result, the riskier small cap index has significantly outperformed the large cap index in 2009, up 54.3% versus a rise of 30.0% for the S&P/TSX Composite. If this trend holds, it will be the first year since 2003 that small caps have outperformed large caps.

We have been unusually active in shifting stock weights in the portfolio in 2009. The reason for this is that the tremendous rally in small caps has provided opportunities for us. Our weights in the more economically-sensitive sectors (Energy, Industrials and Consumer Discretionary) were reduced, and our weights in several other sectors (Information Technology, Health Care, Financials and Consumer Staples) were increased. Overall, we retained a broadly diversified portfolio with considerable exposure to a cyclical rebound in the economy, but we built up our weight in some companies with more stable growth characteristics.

This is the right part of the economic cycle for small caps, as they typically outperform large caps coming out of recessions. The long-term prospects for small caps remain attractive. However, the market has built upside momentum and we think investors are being overly optimistic on the pace of the recovery. We would not be surprised to see a pause or a pull-back in the market in the short-term as the euphoria generated over the end of the recession gives way to the reality of a slower-than-expected recovery.

## Mutual Beacon

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The Fund outperformed the benchmark S&P 500 Total Return for both the third quarter and year-to-date, in Canadian dollar terms. Two key contributors in the quarter were Tenet Healthcare and News Corp. Tenet’s shares rose on positive earnings news, the raising of full year EBITDA guidance and an upgrading of its credit rating outlook. News Corporation shares benefited from an anticipated cyclical recovery in advertising and expectations that significant cost cuts made at the company will convert even modest revenue recovery into incremental earnings growth.

Detractors from performance included Qwest Communications and Marine Harvest. Qwest shares declined as consumers continue to disconnect fixed line telephone connections in favor of mobile only service

or cable provided VOIP (voice over internet protocol). Marine Harvest shares languished as Europeans bought less imported salmon during the summer holiday period. This seasonal trend weakens the price of salmon during this time of the year and weighed on Marine Harvest shares.

We continue to selectively invest in equities with attractive discounts to our estimate of intrinsic value and possessing what we estimate to be limited downside risk. We have found several attractive valuations in financials, some energy-related positions, and in merger arbitrage. At the end of the quarter the Fund was over 69% invested in undervalued equities, slightly more than 6% invested in distressed situations, slightly less than 9% invested in merger arbitrage and held the remaining balance in cash. For its non-U.S. dollar exposure, the Fund was approximately 85% hedged to the Canadian dollar.

## Mawer International Equities

**Gerald Cooper-Key, CFA**

*David Ragan, CFA  
Portfolio Managers, International Equity  
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Stock markets have rallied unabated in the face of lackluster corporate earnings and poor overall global health: the MS EAFE index is up 10.2% this quarter. The Mawer World Investment Fund outperformed and was up over 12.9% this quarter.

It would be unreasonable to expect the economy to return to normal economic conditions after such a tumultuous credit crisis. It is within this logic that we remain skeptical of current valuations; they appear to dismiss the possibility that the global economy dips again into recession. Accordingly, we will look to reduce some of our more economically-sensitive positions that have performed well for us over the quarter. We will also look to increase exposure to structural growth themes, such as increased environmentalism and the global need for infrastructure.

Valuations are less attractive than they were two quarters ago when most stocks were heavily discounted. Finding some margin of safety is certainly more difficult in this environment (though it remains significantly easier than in 2007). Fragile investor confidence is resulting in stock price volatility and is creating market opportunities for watchful investors. A disciplined investment process is one of the best tactics to ensure that the investor is exposed to these opportunities when they present themselves. Prudent investors need to stick to the game plan.



## Trimark International Companies

**Judith Adams, CFA, MBA**

*Portfolio Manager, International Equity  
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Trimark International Companies Fund is a portfolio of high-quality companies located primarily in Europe, Australasia, the Far East, and the emerging markets. The portfolio manager looks to invest in companies with strong management, with competitive advantages that should provide opportunities for long-term growth, and that are believed to be attractively priced in relation to their intrinsic value.

The largest individual contributors to Fund performance in the third quarter were Li & Fung Ltd., a Hong Kong-based consumer goods sourcing company; and adidas AG, a German-based sports apparel manufacturer. Li & Fung is a very well managed company that has performed beyond analysts' consensus expectations. The company has had good success in its cost-control efforts and in gaining new business and the market has responded positively to these developments. Li & Fung enjoys strong secular growth prospects from outsourcing trends in consumer products, and is leveraging its expertise and business relationships across Asia. adidas' share price bounced back after being significantly undervalued. The company's CEO agreed to a contract extension, and the outlook for the rest of the year is positive.

The two largest detractors from Fund performance were Reed Elsevier PLC, a London-based global publisher and information provider; and Suzuki Motor Corp., a Japanese small car manufacturer. Shares of Reed Elsevier declined when the company announced a secondary share offering to help reduce the company's debt load incurred from an earlier acquisition. The company had originally planned to divest one of its businesses to help fund the acquisition, but failed to do so when the stock markets collapsed in response to the global financial crisis. Suzuki's stock price fell after the company announced that quarterly results had weakened on lower auto demand. Suzuki's share price had been strong over the first half of the year, and so the decline was also likely related to profit taking.

No new positions were added to the Fund in the third quarter. One name that the Fund added to was Nestlé S.A., a Swiss-based food company. Nestlé is a world leader in its field, has opportunities for long-term growth, a strong balance sheet and generates positive free cash flow. C&C Group PLC, an Irish cider company, was significantly reduced in the portfolio. The portfolio manager believes that the benefits from the restructuring program that was implemented by new management have been reflected in the share price.

Markets in Europe, Australasia and Far East (EAFE) were up strongly in the third quarter on renewed confidence that the worst of the economic downturn had passed. The market rally continued to be led by the financials sector, as well as by the materials and industrials sectors. All sectors, however, generated positive returns in the quarter (on a Canadian-dollar basis). Emerging markets also had positive returns, led by Asia (ex Japan) and Eastern Europe. The portfolio manager believes significant challenges and risks remain in the economy. The Fund is positioned in high-quality companies with strong balance sheets; those with the ability to generate cash flow and gain market share in a difficult environment. These companies should benefit from the above-mentioned traits as the economy improves.

## Templeton Global Smaller Companies

**Brad Adams, CFA, MBA**

*Portfolio Manager, Global Equity  
Franklin Templeton Investments*



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Templeton Global Smaller Companies Fund outperformed the MSCI World Total Return Index for the third quarter of 2009, as small cap stocks continued to reap benefits disproportionately from the overall rally in global markets. The Fund's holdings in all 10 GICS sectors contributed to relative returns, with its Consumer Discretionary positions the standout performer primarily due to positive selection effect. We had built many of these positions during the recent market downturns as valuations in this sector reflected, according to our analysis, a near write-off of the U.S. consumer as an economic driver. This was an overly pessimistic outlook in our opinion, so key purchases were made in this arena. As such, with the markets bouncing back overall and marginal improvements in the U.S. consumer outlook by period end, the Fund benefited from its exposure to this sector.

While the Fund realized relative gains in all sectors, selection effect in Industrials, Financials and Information Technology were notable contributors. On a regional basis, exposure to Asian emerging markets added value, in particular the Fund's holdings in South Korea, Thailand and Taiwan. The Fund also benefited from an underweighted position and security selection in the United States.

Security selection in Europe was a contributor to relative value overall, driven by the strong performance of holdings in the United Kingdom, Netherlands, Spain and Belgium. Overweighted exposure and security selection in Australia and security selection in Hong Kong and Canada also contributed to relative performance.

## THE COMPASS ADVANTAGE

### **Sophisticated Portfolio Design**

Portfolio design from a comprehensive inventory of investment ingredients.

### **Professional Management**

Management expertise with access to the latest market information and research.

### **Premium Quality**

Best in class investments objectively selected with proven records of value-added performance.

### **Exceptional Value**

High quality investment portfolios at low cost equals exceptional value.

### **Simple to Maintain**

Automatic re-balancing and consolidated reporting of a well-diversified portfolio.

### **Questions?**

Talk to an ATB Investor Services professional at any ATB Financial branch or call 1-888-ATB-7121.

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