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Thursday, October 16, 2008

Third Quarter 2008

From the perspective of Thanksgiving weekend, the end of the third quarter seems like a long time ago, but measuring returns to the quarter's end does facilitate comparisons. The double-digit declines suffered by stock markets are detailed in the attached Benchmark Returns. Also enclosed is a table which lists your returns for the previous calendar years and the first nine months of 2008, as well as various unmanaged indices representing stock, bond, and cash markets.

In the midst of what Warren Buffett recently called the "biggest financial crisis of my adult life" and after the worst week in the 113-year history of the Dow Jones Industrial Average, it is hard to think straight. But over the years I've spent a lot of time worrying about worst case scenarios, such as the 100-year event I referred to last quarter. My personal philosophy has always been to expect the worst and hope I'm not disappointed. Lately though, I've been disappointed. Our investment philosophy has been designed with such eventualities in mind.

The basis of our investment philosophy is that the future is uncertain. Therefore, we manage only balanced portfolios with pre-set limits on how much and how little can be invested in stocks. My definition of the right asset allocation means not having to sell on unfavourable terms and of being able to buy into a panic. Warren Buffett famously says that the time to be fearful is when others are greedy and the time to be greedy is when others are fearful. But just because investors have never been more panicked does not mean to me that stocks can't get cheaper. Therefore, we're trying to buy very gradually, as no matter how low stocks go we want to be able to keep buying. We also don't want to underestimate how long stocks stay depressed. In our recent purchases we're emphasizing income. Steady income into the portfolio should help sustain staying power.

Another Buffettism is that in an ordinary lifetime you can expect to see one or two, or if you live long enough, perhaps three really good opportunities to buy stocks. Right now may be one of those times and governments do seem to be seriously addressing the liquidity problem. Banks, paranoid as they've become about counterparty risk, had stopped lending, and the recent measures by the worlds' governmental authorities are addressing that problem.

But collateral values, particularly real estate, are still falling and real world economic affects have only begun to be felt. The real estate market will likely take a couple of years to get back into equilibrium and unemployment will be rising for at least the next few quarters. If this is an historic buying opportunity, that won't be clear for several years yet.

The Canadian stock market has been particularly hard hit in the last three weeks as energy and metal prices have collapsed. The theory that demand from ‘Chindians’ would offset falling demand in the U.S.A. is, for the first time since it became popular five years ago, being challenged by a global recession.

During the stock market rout of 1974 when stocks fell about as much as they have this year, Warren Buffett wrote in his annual letter to Berkshire Hathaway shareholders that he felt “like a kid in a candy store”. But it was not until years later, after stocks and the economy had recovered, that others understood his earlier giddiness.

Our own approach is, again, to keep the proportion of your portfolio that is invested in stocks relatively steady. To buy gradually into declines. To emphasize companies that have strong balance sheets and profitability. Yet another Buffettism is that after Warren Buffett buys a stock they might as well stop trading for ten years for all he cares. His point is that when he invests he acts like he is buying a business and therefore he cares about how the business is doing and not how the stock is doing. None of the companies we’re invested in has reduced their dividend, although the stock market appears certain that they will. Likewise, I’m convinced many companies are worth more than zero, much as the stock market seems to doubt it these days. Because of their better-than-average balance sheets and profitability, many of our companies will arise stronger than their competitors, however long that takes. In the present panic such distinctions are not being made.

Berkshire Hathaway’s co-chairman, Charlie Munger, has explained that Berkshire Hathaway is organized so that anyone would have to be crazy not to lend Berkshire money, and just in case the world goes crazy, they have a backup plan. Over the last few weeks, Berkshire has invested over \$10 billion in stocks (that we know about) but he recently said that they’ll keep at least \$10 billion or so on hand in case of emergencies. Our own safety net is government-guaranteed and high-quality bonds. The old saying is that in a bear market whoever loses the least wins. The crisis can only be approached as an opportunity if we always have reserves with which to profit from others forced selling.

Today I can only emphasize that we take our responsibility to manage your life savings seriously. The unprecedented uncertainty of the last few weeks (of 20 days with the biggest intraday trading ranges since January 1987, seven have occurred this month, which is only half over) is very upsetting but if you would like to discuss the value of your portfolios on any given day (or the markets, your investment policy, including your tolerance for risk or anything else), please call.

Sincerely,
George Stedman, CFA
Portfolio Manager

P.S. Please visit us at www.georgestedman.com