

Reality Sets In

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It's been a significant challenge plotting a direct course through the unprecedented volatility of the past 18 months. As our second quarter assessment of Canadian market and global economic factors demonstrates, we're seeing progress as conditions line up for a recovery based on corporate fundamentals. Nonetheless, overhanging macroeconomic themes will continue to make the recovery a grind. Here's how our scorecard adds up:

| Factors | Canada | View | U.S. | View | International | View |
|------------------------|--|------|---|------|--|------|
| Corporate Fundamentals | - Price/book valuations down to 1.63X | Neu | - Price/book valuations down to 1.8X | Neu | - Eurozone equity valuations down 20% YTD | Pos |
| | - Net profitability still high at 7.34% | Pos | - Net profitability near record high of 3% | Pos | - Asia (ex Japan) price/earnings 13x | Pos |
| | - YOY earnings growth 14%, but estimates revised down 4% | Neu | - YOY earnings up 40% | Pos | - Eurozone expected earnings now 37% | Pos |
| | - Expected earnings growth 13% ('10) & 19% ('11) | Pos | - Majority of corps beating expectations despite 4.2% positive revision | Pos | - Asia (ex Japan) YOY earnings up 35% | Pos |
| Asset Mix | - S&P/TSX Composite dividend yield of 2.9% rivals 10-year bond yield | Pos | - S&P equity yield of 2.1% below 2.9% on 10-year Treasury bill | Neu | - Euro equities over bonds on yield 3.3% | Pos |
| | - Equities back to neutral from overbought | Neu | - Equities back to neutral territory | Neu | - Asian equities over bonds on growth prospects | Pos |
| Technical Analysis | - Equities back to neutral from overbought | Neu | - Equities back to neutral territory | Neu | - EAFE & Asian valuations near long-term average | Neu |
| Volatility | - MVX index higher in Q2 but below '08 high | Neg | - VIX futures showing June volatility | Neg | - Debt contagion fears easing on Eurozone measures | Neg |
| Investor Sentiment | - Bearish on slowing recovery | Neg | - Bearish on slowing recovery | Neg | - Eurozone sentiment edged up in June | Neu |
| Economy | - Employment declined to 8.1% in Q2 | Pos | - U.S. unemployment still 10% | Neg | - European austerity measures reducing GDP to .2% | Neg |
| | - Capacity utilization rate 75% | Pos | - Manufacturing capacity improving at 74% | Pos | - Asian production supported by domestic demand and infrastructure build | Pos |
| | - Real GDP of 3.3% indicates moderate recovery | Pos | - Real GDP weak @ 2.7% | Neg | - Chinese economy achieving soft landing | Pos |
| Fiscal Policy | - Deficit spending manageable | Pos | - Deficit spending facing resistance | Neg | - Spreads moderating after sovereign debt crisis in Euro zone | Neg |
| Interest Rates | - BOC resuming tightening | Pos | - Fed keeping accommodative stance | Pos | - U.S. dollar up 15% up against euro | Pos |
| Currency | - Slack commodities moderating CAD strength | Neu | - Currency up 5% since April | Neg | - Chinese inflation/real estate values in check | Pos |
| Inflation | - Inflation rate down to 1.4% | Pos | - Moderate at 2% | Pos | - Chinese inflation/real estate values in check | Pos |
| Net Position | | Pos | | Neu | | Pos |

Neu: Neutral, Pos: Positive, Neg: Negative

It's clear why Canada is a favoured country for international investors, while in the United States a definite dichotomy between corporate fundamentals and economic conditions still exists. The positive assessment for International markets has to be further dissected as Europe and Japan continue to exhibit too much debt and not enough stimuli. Asia and South America remain the true drivers in the mix and are sufficiently self-funding to justify our positive outlook for their markets.

Taking Action

Our investment strategy remains unchanged. Given healthy dividend yields on stocks, we favour equities over bonds, while the defensive nature of dividend companies comfortably handles ongoing market volatility.

Given record cash holdings of companies' world wide, the tipping point in our balance of factors has arrived. In the next few quarters, corporations will either feel confident enough to invest their cash in new opportunities and ignite real economic growth, or they will simply sit on cash and distribute it to investors. Based on our positioning, we're confident portfolios will continue an upward trajectory. ■

OUR CURRENT INVESTMENT STRATEGY (for the period June 30 to September 30, 2010)

| ASSET CLASS | STRATEGY (LONG-TERM) | TACTIC (SHORT-TERM) | ACTIVE BALANCED PORTFOLIO |
|----------------------|----------------------|---------------------|---------------------------|
| Cash | Neutral | Unchanged | 0.00% |
| Fixed Income | Neutral | Increasing | 45.00% |
| Canadian Equity | Neutral | Unchanged | 40.00% |
| U.S. Equity | Neutral | Increasing | 7.50% |
| International Equity | Neutral | Decreasing | 7.50% |



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