A QUARTERLY PUBLICATION FOR OUR INVESTORS

MATCO REPORT

FALL 2010, ISSUE 11

The End of the Beginning

— BILL K. DICKIE, CFA, PRESIDENT & PORTFOLIO MANAGER

— JERRY A. OLYNUK, LLB, CFP, CFA, VICE PRESIDENT & PORTFOLIO MANAGER

Our title draws on Sir Winston Churchill's famous speech where he captured a perceptible shift in his country's fortunes, which at one point had seemed hopeless. Today, our economic fortunes are experiencing a similar shift despite a decidedly negative overtone. As we deliver this report, the U.S. economy shows signs of stalling and the wild card of an Irish debt default is raising the temperature of financial markets again. Yet, investors are set to benefit from a range of positive returns across most financial asset classes in 2010. While it may not seem apparent, a shift in political will among developed nations is laying the groundwork for long-term solutions that will preserve and build upon the gains of the past year.

Inflation versus deflation remains the immediate policy challenge for most countries. Governments in China and Asia are handling the conundrum of managing domestic demand while supporting a global economic recovery. The bubble in Hong Kong real estate values may not concern the average Canadian, but any effort by the Bank of China to slow the flow of speculative capital by raising interest rates reverberates through oil and commodity prices, and ultimately our stock market.

On the other hand, the U.S. Federal Reserve Board (the Fed) has implemented another round of "quantitative easing" (read printing money) to deal with a flagging recovery. China and other growth economies have criticized U.S. policy, as they fear the hot money injected into the American economy will not find its way into the hands of U.S. small businesses and consumers, but will rather flow to their economies, further fuelling inflation. However, at this point, the Fed is prepared to risk the prospects of future inflation in an effort to combat a stubborn unemployment rate and anemic consumer spending.

As markets assess the impact of quantitative easing, political events are providing the real shift from short-term crisis management to long-term policy solutions for our current economic malaise. It may be surprising that eurozone governments have led the way on fiscal responsibility. Given the near disintegration of the euro, governments starting with Greece and Spain, and very soon Ireland, have had no alternative but to adopt austerity measures despite the threat of social unrest. Next, U.K. voters gave their Conservative party a mandate sufficient enough to implement a series of no-choice cutbacks immediately after the election. The defining step came in the United States when voters, alarmed by the threat to their economic well-being, set aside the reformist agenda of the Democrats in favour of a more conservative agenda to start balancing the books. As in Canada, the solution will likely involve a combination of cutbacks at all levels in order to stem the deficit, and stimulative measures to grow GDP relative to accumulated debt. However, the muted pace of the U.S. recovery, even with strengthening corporate results, has conclusively demonstrated that reducing debt at all levels is necessary to reignite the virtuous cycle of re-investment and growth.

Taking Action

So what's changed? For the time being, the premise of getting paid while you wait remains sound as companies gird their balance sheets against near-term softness in the economy. The threat of a "bond bubble" has momentarily stemmed the flight to quality, and the reality of rising yields based on expected inflation leads us to continue underweighting bonds and adding preferred shares for superior after-tax income. Materials and basic industries, meaning the Canadian economy, will continue to perform even as China's growth moderates. Gold, in particular, will maintain its value based on its relationship to a weak U.S. dollar. The real signal of change will be renewed strength in the Financials sector as banks resume normal course lending to business and consumers. Consumer stocks will likely lag through the first part of 2011, but the surprising resurgence of airline and auto stocks already demonstrates the consumer is on the mend. Here's to new beginnings in 2011. ■

OUR CURRENT INVESTMENT STRATEGY (for the period September 30 to December 31, 2010))

ASSET CLASS	STRATEGY (LONG-TERM)	TACTIC (SHORT-TERM)	ACTIVE BALANCED PORTFOLIO
Cash	Neutral	Unchanged	0.00%
Fixed Income	Under	Unchanged	45.00%
Canadian Equity	Over	Increasing	45.00%
U.S. Equity	Under	Decreasing	5.00%
International Equity	Under	Decreasing	5.00%

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The Markets According to Earnings

— LEE W. APPLETON, CFA, PORTFOLIO MANAGER

Over the last year, investors have kept close watch on Canadian corporate earnings reports and the recovery clues they provide. Markets have been ultrasensitive to each tidbit of news. Now, as the latest round of reports continues to flow, we believe the investment horizon is generally positive. Though on a year-over-year basis the pace of earnings acceleration has flattened somewhat, we continue to see signs of ongoing recovery in both reported and expected earnings.

So far in the condensed third quarter earnings season, we're pleased to report that 64% (109 of the 169) of companies in the composite have met or beat their earnings expectations. Based on these positive reports, analysts have increased the forward estimates for these companies. Generally, we view both of these events as positive catalysts for the markets. Rounding out 2010, we expect corporate Canada will produce 678 in earnings, a healthy step up from 599 in 2009.

As volatility or perceived risk during the third quarter continues to wane, we have watched valuations of the S&P/TSX Composite Index reach 19x trailing earnings, up from 17x in the second quarter of 2010. We believe a combination of factors, such as investors' search for alternatives to low savings account interest rates and rock bottom Government of Canada bond yields, positive market catalysts, seasonality and decreased market volatility, equals good opportunity for equities. Given positive earnings expectations and a market multiple of 19x, we have set a low target valuation for the S&P/TSX Composite Index of 12,882 points for 2010. However, if volatility declines further and investors become increasingly willing to commit more capital to the equities market, we would not be surprised to see the market value reach 13,221 with an accompanying risk multiple of 19.5x.

As companies continue to tell their earnings stories, we're focused on equities with strong profitability, reasonable multiples and healthy dividend yields. Moving through this typically strong season for markets, we're targeting low cash balances and positive returns for Q4. Looking at the balance of 2010 and the first quarter of 2011, we're optimistic about the overall market and high-quality companies in particular. In our view, any short-term market setbacks will provide buying opportunities. ■

A Calculated Approach

By multiplying market earnings with three different price-to-earnings valuation scenarios based on perceived risks, we can establish reference points for composite values and expected returns.

September 30, 2010
S&P/TSX Composite Index: 12,369
Earnings for 2010*: 678

TRAILING P/E SENSITIVITY		VALUE OF COMPOSITE INDEX	
		Earnings per share 2010	Expected Return
Higher Risk Price/Earnings	20	13,560	10%
Quarter-End Trailing Price/Earnings	19	12,882	4%
Lower Risk Price/Earnings	17	11,526	-7%

*CPMS Calendar Earnings Estimates

Reading Between the Lines

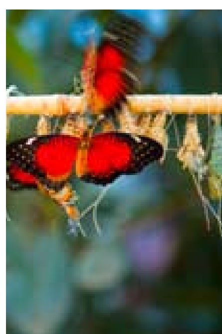
— LEE W. APPLETON, CFA, PORTFOLIO MANAGER

As the market gravitates towards obvious good news, we continue to seek out those companies who, at first glance, don't present well. They're companies that are publically perceived as being far from stars but, based on our research and analysis, we believe present real opportunities. Reading between the lines of earnings reports, we avoid value traps and purposefully choose companies before they become favourites with investors. Here are a few examples.

Domtar Corporation, which was highlighted in the last edition of the *Matco Report*, continues to adhere to our discipline of "pay less, get more." Domtar is delivering more, ranging from more earnings to better margins and exceeding analysts' expectations. We continue to view Domtar as reasonably priced—valued at 7.7x trailing earnings and 1.2x assets.

Magna International Inc.

- Magna is recognized as "the most diversified automotive supplier in the world. As of September, 2010, the company had 245 manufacturing operations and 80 product development, engineering and sales development centres in 25 countries on five continents."*
- This is a cyclical company that experienced extreme margin compression from fall 2008 until January 2010.
- This company has been on our radar as of spring 2010 when sales began to increase once again. Since that time, Magna International has been delivering strong sales rates and earnings per share; however, we expect the pace to temper somewhat over the near term.
- Review of their post-recession trends in the early '80s and '90s showed the company's price-to-book multiple expanded 3x beyond book value. We purchased Magna International stock at 1x book value and believe the company is on track for a positive post-recession recovery.
- We believe positive catalysts, such as the company's multi-share restructuring to a single class, and founder Frank Stronach's releasing tight control over the company, will contribute to further multiple expansion.



Research In Motion (RIM)

- Founded in 1984, the Waterloo-headquartered company is world famous for its BlackBerry and has offices throughout North America, Asia-Pacific and Europe.**
- We believe RIM is a pay less, get more opportunity in action. Measured on forward earnings and trailing earnings, it ranks as one of the top 20 best valued companies on the S&P/TSX Composite Index. Relative to U.S. and international peers such as Apple Computer, Inc., Motorola, Inc. and Nokia, the firm continues to look very attractive.
- This is a high-margin company with strong profitability, solid earnings trends and a strong balance sheet, including significant cash reserves. RIM has an excellent history of revenue growth in both strong and weak economic times.
- The introduction of the new PlayBook tablet in 2011 opens a new market and sets the stage for increased revenues and earnings. ■

* www.magna.com
** www.rim.com

KEY INVESTMENT CHARACTERISTICS		RESEARCH IN MOTION LTD.	MAGNA INT'L INC.	MFi CANADIAN EQUITY	S&P/TSX COMPOSITE
Quality	Profitability Return-on-Equity (%)	38.8	11.4	17.8	12.4
	Reinvestment Rate (%)	38.6	11.1	8.0	5.5
Income	Yield (%)	0.0	1.5	3.6	2.5
Growth	Bottom-Line Growth (%)	7.1	27.6	6.2	3.2
Value	Price-to-Earnings	10.7	12.2	13.3	18.9
Risk	Beta-5 Years vs. S&P/TSX	1.7	0.7	0.8	1.0

As of November 15, 2010, CPMS

Fluid Opportunity Sparks Interest

— DANIEL S. CHENG, CFA, PORTFOLIO MANAGER

Liquids-rich gas is attracting the attention and capital of Alberta oil and gas producers. As natural gas prices remain stubbornly weak and the disparity between natural gas and oil prices widens, the shift to liquids-rich gas is viewed as a step in the right direction, particularly for players without oil assets.

Key Factors

- Generally speaking, liquids-rich gas is natural gas that also has some heavier hydrocarbon components separated out as liquids, which are referred to as natural gas liquids.
- Natural gas liquids—used in the petrochemical industry and as diluent for blending heavier crude oil grades and as fuels such as ethane, propane, and butane—are more valuable than natural gas as they typically trade in relation to oil prices. These days that reality is a welcome relief from bargain basement natural gas prices.
- Products are generally consumed in Alberta, with the balance shipped to Ontario and exported to the United States.
- Liquids-rich gas plays that are currently active in Alberta include the Glauconite, Bluesky, Montney, Notikewin, Nikanassin, Rock Creek and Dunvegan. In the current environment, many such plays have better economics than a lot of oil plays due to factors such as the premium pricing for liquids, decline profile of the wells, initial production rates and royalty incentives. Dramatically improved well economics can ultimately improve cash flow.
- Looking at drilling and service companies, we're seeing some good news as the focus on liquids-rich gas, along with oil resource plays, is sparking some drilling opportunities, particularly for those firms with horizontal drilling and multi-stage fracturing capabilities.

Our View

We expect the shift to liquids-rich gas to be a short- to mid-term trend, an interim measure until natural gas prices find balance and begin to move higher. We see opportunity in the valuation disconnect between oil-weighted and natural gas-weighted companies. Reflecting the disparity in commodity prices and the limited number of oil-focused junior and intermediate energy companies in which to invest, oil-weighted stocks are currently trading with significant premiums on a production and reserves basis ($150k/boe/d+ on an EV/BOE/D), while natural gas-weighted companies are trading significantly lower ($50k/boe/d). Many junior and intermediate energy companies with liquids-rich natural gas plays are trading at pure natural gas-weighted company multiples when we believe they should reflect a higher multiple. We expect their valuations will improve as investors recognize the value of the plays and the focus on liquids-rich natural gas. Additionally, exposure to companies with liquids-rich gas still provides exposure to natural gas prices and the leverage opportunity that accompanies higher gas prices heading into the winter heating season. While we continue to favour oil-weighted companies, when applying the liquids-rich theme within the MFi Energy Fund, we like names such as Angle Energy Inc., Bonavista Energy Trust Ltd., Vero Energy Inc., Daylight Energy Ltd., Delphi Energy Corp., and Orleans Energy Ltd. We're already seeing progress as investors are starting to reward producers' recent commitment of capital to producing liquids-rich gas. ■

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