

The Challenge is in the Descent

— JASON N. VINCENT, PFP, TEP, CHIEF OPERATING OFFICER AND VICE PRESIDENT, MULTI-FAMILY OFFICE

It's a long way up as a young adventurer facing a tall tree or steep rock face to climb. What do you do? You focus on getting to the top. Upon arriving there's that great feeling of accomplishment, savoured only until the moment you realize getting down safely poses an equal, if not greater challenge.

The current economic and market environment conjures up such images. Clearly, 2009 belonged to the world's central banks and major governments as their aggressive fiscal and monetary policies successfully stopped the dramatic decline in asset values and sparked the re-inflation of assets from March 2009 lows. Their actions have been essentially propping up asset values through direct injections of capital into the private sector and by making capital cheaper through historically low interest rates.

The short-term focus for central banks and governments has been on the upward climb. It's difficult to be critical of this approach, as throughout 2008 and 2009 there were few alternatives to halting the globally critical situation. However, the reality is that at some point in the future, central banks and governments will have to start climbing down from the high levels of support. One way or another, we'll need to navigate the direct or indirect consequences of that descent.

As pundits debate the prospects of higher inflation and rising interest rates that are likely to accompany the withdrawal of support, we believe the more critical question is: Where are we in the economic recovery?

In our view, we're in the early stages of a prolonged recovery that will present significant challenges along the way. In the near-term, our outlook is positive as we watch capital continue to flow back into the marketplace. Looking longer term, we believe we're participating in the re-wiring of global trade patterns that have existed since the second world war. Since that time, countries around the world have relied on the voracious appetite of U.S. consumers and a lower domestic currency to ensure an exporting advantage over the United States.

Over the past year, we've watched the widespread depreciation of the U.S. dollar against the world's major currencies and we've seen the export advantage of countries such as Canada decline. This trend poses real challenges for our domestic economy. Countries such as ours must find ways to counter a stronger currency with greater productivity and new and sustainable trading relationships beyond our number one trading partner, the United States.

From a U.S. perspective, we believe their course of action is clear—continue to keep the dollar and interest rates low to attract economic activity and keep foreign interest payments at relatively lower levels.

We recognize such macro trends will take years to evolve. As investors working through the early stages of a schizophrenic economic recovery, we believe our strategies are well-suited for this environment. In our view, it's important to:

- Own high-quality companies that can operate in a volatile and lean environment and potentially grow relative to the competition.
- Minimize risk as we believe this current environment is not going to reward risk taking to the same degree investors experienced during the last two or three business cycles.
- Be paid a higher yield on assets as it will be the foundation of your total return.
- Align growth components of a portfolio with developing countries such as China and India through strategic exposure to commodities.

In pursuing such strategies, we believe portfolios will be better positioned to safely participate in the twists and turns economies and markets present as central banks and policymakers climb their way down from the currently lofty levels of support. ■



MATCO FINANCIAL INC.

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The result is strategies that help you shape what comes next, now and for generations. Strategies that integrate the investment portfolios, trust, estate and tax plans developed exclusively for you. Strategies that can be implemented seamlessly by our group or in concert with your advisors. Finally, consolidated reporting that gives you a comprehensive view of your wealth—raising hidden weaknesses and new opportunities. **This is what we do.**

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Matco Financial Inc.

Preparing for the Next Investment Decade

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

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

Now is when investment managers generally recap the past year and draw forecasts for the forthcoming one. Clearly, market events of 2008-2009, and the effects of recession are still top of mind. In fact, as we enter 2010, they appear to be overshadowing the market impact of the past 10 years. Putting the last 15 months or so in context of the entire decade, we believe investors can gain a better sense of the way forward.

The millennium started with the bursting of the technology bubble in 1999-2000, followed by three consecutive years of negative returns. Markets were also struck by the exogenous shock of the 9/11 attacks and a correction of 26.0% in 2002. This was followed by the longest bull market in history, which started in 2003 and peaked in 2007-2008.

Essentially, we've seen a great divide in market conditions over the past 10 years. Whereas innovation and speculation in technology and telecom stocks at the decade's start was largely a sector phenomenon, the last five years featured a remarkable regional shift of wealth and resources from developed to developing nations, particularly to Asia and the Middle East. At the same time, each market phase exhibited a speculative bubble, first in technology stocks and latterly in global real estate, both fuelled by low interest rates.

How did 2000 to 2010 translate into returns? On an index basis, the past decade was unkind to equity investors. Despite the roaring results of Canada's bull market, the S&P/TSX Composite Index return of 5.6% (January 1, 2000 to January 1, 2010) underperformed the Canadian bond market. In the United States, the S&P 500 Index generated a negative total return of -1.0% over a decade—the first time in recorded history. European stocks suffered a similar fate with the MSCI EAFE Index posting a -1.7% return over 10 years. Not surprisingly, the Pacific region (ex-Japan) turned in positive returns (2.3%) as did countries in the orbit of Asian growth, including Canada and Australia. China's emergence as part of the BRIC countries drove those returns, especially in the last five years.

On a sector basis, commodities fared best as Materials and Energy rose at least 5.0% due to strong demand from Asia. Technology and telecommunications companies exhibiting the scars from the crash of 2000 provided the worst return of -8.0%.

Taking Action

We think there are key lessons to be gleaned from the net investment results of the last 10 years. First, such numbers challenge established investment strategies such as buy and hold or indexing. Growth trends—whether in technology or emerging markets—can be transitory and unrepeatable. Therefore, we believe, as over the past decade, opportunities for stronger results lie with the active investor that takes a bottom-up, disciplined and prudent approach to the markets.

Second, the numbers reinforce the decade's trends of increasing reliance on technology, globalization, the growth of BRIC economies and their demand for commodities. Despite the dislocation caused by the technology bubble, its legacy stands in companies such as Apple, eBay and Google, which are now an integral part of the global economy. Unfortunately, the United States and Europe face major challenges in stimulating economic growth while paying for excesses of the 2000s. Developing nations face a comparable challenge in promoting growth without encouraging the speculative asset bubbles that have injured Western economies. Over the next decade, we expect emerging and developed market trends to become mutually beneficial as the United States and Europe reassert their manufacturing expertise by exporting goods and services to developing countries in order to rebalance their fiscal burdens.

Entering 2010, we remain committed to the dominant trend of the decade—emerging market growth and the corresponding demand for commodities, both of which faltered in 2008, but have now recovered. In the near term, we recommend clients start rebalancing toward their strategic allocation in fixed income as their portfolios recover and the post-recovery rally's momentum slows in the latter part of 2010. It's time to get ready for the next decade of investing. ■



OUR CURRENT INVESTMENT STRATEGY (for the period December 31, 2009 to March 31, 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 | Decreasing | 40.00% |
| U.S. Equity | Neutral | Unchanged | 5.00% |
| International Equity | Neutral | Decreasing | 10.00% |

Investing in Reality

— LEE W. APPLETON, CFA, PORTFOLIO MANAGER

It's official. Canada's recession is over according to the gross domestic product figures of December 2009. We're in the free and clear with expected 2009-2010 corporate earnings growth sitting at 20.0%. Or, are we? Based on our research and analysis, we believe market sentiment remains ahead of itself. We think there's a gap between investor attitudes and the economic realities and market results we'll likely experience over 2010. That's why we continue to build portfolios based on "real" fundamental strength, with each asset playing a substantive role in generating results that are expected to consistently outperform the benchmark S&P/TSX Composite Index. Looking at the Matco Equity Income portfolio, for instance, our asset selection criteria focuses on companies that:

- are profitable enough to produce higher dividend yields than the market;
- present a lower price-to-earnings multiple than the market; and
- based on the combination of the above, deliver lower volatility than the benchmark.

Looking "inside" the portfolio, you'll see an asset's contribution to overall portfolio strength at times supersedes its individual attributes. Take the following two companies for example:

North West Company Fund

North West Company Fund owns The North West Company, which is recognized as "a leading retailer of food and everyday products and services in rural communities and urban neighbourhoods across northern and western Canada, Alaska as well as the South Pacific and Caribbean." It has approximately 6,800 employees and 223 retail locations. This asset has been part of the Matco Equity Income portfolio for 14 months, and as the table below shows, the company contributes positively in terms of all key portfolio characteristics. More specifically, the holding yields over 7.0% and its return-on-equity is very strong at 29.0%. (In our view, profitability and margins serve as important indicators of sustainable dividends). With a multiple of 11x earnings, we think North West is the most reasonably priced stock in the Canadian Consumer Staples, Food and Drug Retailing sector, while their noncyclical bottom-line earnings growth is strong relative to the markets.



Yellow Pages Income Fund

Yellow Pages Group was added to the Matco Equity Income portfolio in November 2009. It's known as "Canada's leading local commercial search provider and largest directory publisher." The Group employs approximately 2,300 people in Canada and 350 in the United States.

You'll see the Yellow Pages Income Fund does not outperform the S&P/TSX Composite Index on all key characteristics. For example, the Yellow Pages Income Fund profitability/return-on-equity and reinvestment rate are, for example, lower than its peer North West Company Fund and the Index. So why own it? Fundamentally this asset "pays" its way by generating yields of approximately 15.0% on an ongoing basis. We expect the company's unit distribution policy to remain consistent given 2010 expected earnings of \$1.01, their reasonable payout ratio of 70.0% on trailing earnings and 60.0% on expected cash flow with dividends of \$.80. In addition, its very reasonable price at 5x earnings per share is very attractive. We view Yellow Pages Income Fund as a long-term opportunity within the context of the portfolio. In the near term, we expect the unit distribution to be the major return contribution until the market recognizes the business has undergone the typical recessionary cycle and not a secular change. When this occurs, we expect capital appreciation to also contribute as investor interest returns.

Working through this uncertain market environment, each asset in the Matco Equity Income portfolio will be selected and kept based on its specific attributes and, as importantly, its role in generating results. Strong key characteristics and prudent risk will, in our opinion, offer the best opportunity for total return, (combined income and capital appreciation), as the market reconciles any differences between the expected corporate earnings growth rate of 20.0% and the real growth of 2010. ■

| | | EQUITY INCOME | NORTH WEST FUND | YELLOW PAGES INCOME FUND | S&P/TSX COMPOSITE |
|---------|--|------------------|--------------------|-----------------------------|----------------------|
| Quality | Profitability/Return-on-Equity ROE (%) | 15.6 | 29.5 | 9.4 | 12.0 |
| | Reinvestment Rate (%) | 7.1 | 5.8 | -0.2 | 4.4 |
| Income | Yield (%) | 4.0 | 7.4 | 14.9 | 2.7 |
| Growth | Bottom-Line Growth (%) | -7.0 | 3.8 | -3.7 | -12.9 |
| Value | Price-to-Earnings | 13.0 | 11.2 | 5.4 | 19.6 |
| Risk | Beta-5 Years vs. S&P/TSX | 0.8 | 0.2 | 0.4 | 1.0 |

As of December 31, 2009, CPMS.

New Beginnings

— DANIEL S. CHENG, CFA, PORTFOLIO MANAGER

With the New Year in its infancy, investors are seeing lingering effects of 2009 and signs of a new cycle in oil and gas taking shape. Here are a few of the Alberta-based trends we're tracking closely:

Exploration or acquisition: Junior and intermediate companies appear to be resuming their role as the industry's research and development department. Where there's success and "derisking" of a play, then acquisition by a larger entity is not far behind. We saw this at work in the Bakken play in Saskatchewan in 2008 and into 2009. A similar scenario is unfolding in Alberta's Cardium play where a number of juniors are active along with some larger entities. MFi Energy Fund investors, for example, have benefited from our early participation in the Bakken play. We're now investing in companies in the Cardium play such as Bellatrix Exploration Ltd., NAL Oil and Gas Trust, Bonavista Energy Trust and Daylight Resources Trust.

Under new management: Increased merger and acquisition (M&A) activity and the sale of junior companies generally mean movement by top tier management teams. With one chapter closed, such teams refocus on struggling junior oil and gas companies, recapitalize them and assume management responsibilities, generating investor interest along the way. Recent examples include Wild Stream Exploration, Inc., Legacy Oil + Gas Inc. and Result Energy Inc.

Upcoming transition: In 2011, royalty trusts lose their tax advantage. We're seeing trust to corporate structure conversions underway with notable examples including: Crescent Point Energy Corp. and Advantage Oil and Gas Ltd. We expect this activity may prompt the re-emergence of the intermediate sector and fuel M&A activity as trusts—in conjunction with their transition—look to add growth assets to their portfolio.

Increasing capital expenditures: Reports indicate some companies are increasing capital expenditures over 2009 with spending levels anticipated to be ~15.0% higher year-over-year in Canada thus far. As discussed in the last *Matco Report*, we think activity will be focused primarily on horizontal drilling and multistage fracturing in resource-type plays in both natural gas and oil (i.e., Bakken, Cardium, Montney, and the Deep Basin). MFi Energy Fund has exposure to these trends through Daylight Resources Trust Ltd., NuVista Energy Ltd. and Progress Energy Resources Corp. to name a few.

Revised royalty structures 2010: Ongoing changes to Alberta's royalty structure and temporary incentives have made it difficult for companies to plan for the long term. We're expecting the scheduled January release of the Alberta Competitiveness Study to introduce some positive stability, setting the stage for oil and gas companies to plan 2010/2011 activities with certainty. We think Alberta producers drilling medium- to deep-gas in the Foothills and Deep Basin will benefit most as they have borne the brunt of the pain in the last two years. From our vantage point, we expect junior companies such as Vero Energy Inc. and Angle Energy Inc. to benefit. Both are currently MFi Energy Fund holdings.

In addition to these local themes for 2010, we'll be working with trends such as developments in liquefied natural gas, global supply/demand and carbon tax issues. Through current and prospective holdings, we believe MFi Energy Fund is well-positioned to capitalize on such trends throughout 2010. Looking longer-term, we remain bullish on the strength of commodities such as oil and gas given the ongoing prospects for growth in emerging markets such as India and China. ■



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