Seymour Investment Management

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Equity markets rebounded strongly in the third quarter as concerns of a double-dip recession and Europe's sovereign debt challenges receded. Fears of a China slowdown eased with the release of economic data that suggests that China is well-positioned for a soft landing, helping to fuel a rally in commodity prices. The S&P/TSX Composite Index achieved a total return of 10.3% during the quarter, with the bulk of the gains attributable to strong performance from resources and financials, while the S&P 500 Composite Index returned 11.3%. Fixed income investments continued to perform well, supported by strong fund flows and anticipation of further quantitative easing in the United States.

The Bank of Canada increased its target for the overnight rate by 25 basis points twice during the third quarter, taking the key rate to 1.0%, which is still very low by historical standards. With the economic recovery decelerating in both Canada and the United States, we believe the Bank of Canada is unlikely to raise rates again for the foreseeable future. The U.S. Federal Reserve has hinted at the prospect of quantitative easing, pointing to inflation that is running below the level consistent with its mandate to promote employment and price stability. Expectations that the Fed will announce another round of quantitative easing increased with the September employment report that showed U.S. unemployment was unchanged at 9.6%.

Our economic outlook is unchanged from last quarter and calls for slow but sustainable economic growth supported by accommodative fiscal and monetary policy. Canada's domestic economy remains healthy with GDP growth that is expected to lead major industrialized countries. The risks to the Canadian economy remain largely external, with a strong Canadian dollar expected to put further pressure on already weak U.S. exports. We do view the Canadian housing market as an area of concern as prices remain high in many markets and are vulnerable to higher interest rates or unemployment.

Despite near-term uncertainty in the economic outlook, the outlook for equities in North America is generally very positive in our view as investors are being compensated for near-term uncertainty in the form of attractive valuations. Corporate earnings are recovering on the back of aggressive cost-cutting and an eventual demand recovery should drive greater earnings power given operating leverage. Corporate balance sheets remain healthy and large cash balances are being directed toward shareholder-friendly buybacks and dividend increases. Strong balance sheets and cheap debt financing are fuelling merger and acquisition activity, which should support equity prices as the value gap between trading prices and underlying values narrows.

Last quarter, we highlighted the record gap between the earnings yield of equities and bond yields as a key reason for our preference for equities over fixed income investments at this stage in the economic and market recovery. With bond yields hovering near record lows and income trust taxation rapidly approaching we expect investors will increasingly look toward dividend-paying securities such as the Canadian banks, REITs and media stocks for yield and capital

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appreciation. History has shown that a strategy of investing in a diversified portfolio of high-quality equities with a consistent track record of dividend growth has outperformed benchmark returns during most periods – particularly during difficult market environments.

Canadian banks reported another solid quarter of financial results in the third quarter on the back of strong retail performance, cost reductions and lower than expected provisions for credit losses. The outlook for Canadian banks is fairly constructive with ROEs in the mid-teens expected over the next couple of years. With greater clarity regarding new capital thresholds, we expect the Canadian banks to resume dividend increases over the next couple of years.

REITs performed well in the quarter on the back of strong fund flows into the sector driven by demand for yield in a low interest rate environment and given the sector's perceived stability. Public and private company acquisitions of real estate have driven up private market prices of many classes of real estate, which in turn are supporting share prices of publicly-traded REITs. We expect commercial real estate will enjoy further price appreciation (or cap rate compression) in this environment of slow growth and low interest rates.

We continue to view media stocks as a core investment given their strong free cash flow generation, solid balance sheets and leverage to the ongoing recovery in the advertising market. We expect the media sector will continue to generate attractive risk-adjusted returns and announce dividend increases. Recent acquisitions of media companies by cable and telecommunications companies have acted as a catalyst and we expect M&A speculation will continue to support share prices.

With this quarterly letter, we have enclosed an update on the Seymour Performance Fund, which enjoyed strong performance in its first full quarter since inception. For additional information on the Performance Fund please call us at (604) 659-1717 or visit our newly-launched website at www.seymourinvest.ca.

Sincerely,

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Kelly Woodall
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