

"Indeed, we have usually made our best purchases when apprehensions about some macro event were at a peak. Fear is the foe of the faddist, but the friend of the fundamentalist."

- Warren E. Buffett, 1994 Chairman's Letter

Investment Perspectives

2011: The Unexpected, and More of the Same

While the global economy avoided tipping into recession, 2011 was not a banner year for investors. It can be summed up as having had slower-than-expected growth and macro-driven market volatility. The fragile recovery was made worse by unexpected events and political missteps. Then, the deepening European debt crisis – and ensuing market instability – knocked growth off course.

In North America, short-term interest rates have remained flat. Any concern about inflationary pressures has taken a back seat to a stalled recovery. Meanwhile, long-term interest rates – both north and south of the border – have declined roughly 35 per cent in 2011. Canada's 10-year bond closed the year at 1.9 per cent. These rock-bottom, long-term interest rates are intended to support private spending, both business and consumer.

Yet, despite a weak global economy, corporations are now fully healed. Companies have been hoarding cash to restore balance sheets and are now holding record

levels of it. Quality businesses report solid profits and currently trade at low relative valuations. In the grip of macroeconomic events however, the financial merits of individual companies, like earnings and growth, don't seem to matter much.

We enter 2012 with the recovery still in rehab. The majority view is that we'll see continued weak-but-positive economic growth in most countries, with those in the European Union being the notable exceptions. The outlook is unusually uncertain because the economy and markets hinge so strongly on macro events.

In these times, our best strategy is to stay close to economic issues and monitor the risks. We continue to practise the general principles of sound investment. While they can be affected in the short term by volatile markets, we believe that the fundamentals of high-quality investments will, in time, exert themselves. *As always, we thank you for your continued confidence and support.*

Equities:

North American markets had almost recovered to their pre-crisis levels by early 2011. Given the residual headwinds to a sustainable recovery, perhaps the market's rebound was premature.

In a risk-averse reaction to the unresolved euro zone crisis, global stock markets staged a synchronized mid-year correction. Throughout the year, the volatility of equity markets rivalled that of 2008.

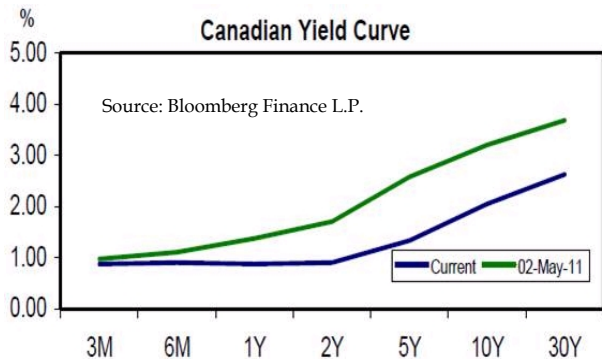
Canada's resource-based economy was negatively impacted by weak commodity prices and slower export growth. Its cyclical sectors – energy, materials, consumer discretionary, and information technology – all underperformed. Financials finished in the red, too. The S&P/TSX shed 16.2 per cent from its April high to close well below its 2010 year-end level, delivering a

performance of -8.7 per cent.

With the best relative performance in 2011, the U.S. economy proved more resilient to the crisis than many expected. The S&P 500 index finished exactly where it started at 1,257. In Canadian-dollar terms, the S&P 500 gained 4.3 per cent due to dividends (2.1 per cent) and foreign exchange gains (2.2 per cent).

At the eye of the storm, the MSCI EAFE lost 9.8 per cent (in CDN\$). All major continental European markets, including France and Germany's, posted negative returns. Emerging markets were down roughly twice the amount of developed markets. The MSCI Emerging Markets index lost 18.1 per cent in 2011 after gaining 19.2 per cent in 2010 and 79.0 per cent in 2009 (in US\$).





Fixed Income and Interest Rates:

Central banks are now of one mind: keep short-term interest rates low. The Bank of Canada and the U.S. Federal Reserve expect to leave their key policy rates as is – 1% and 0.25%, respectively – until at least 2013. In 2012, the Federal Reserve plans to release officials’ forecasts about the trajectory of interest rates. In doing so, it hopes to boost growth by delaying expectations of an increase.

In 2011, plunging bond yields expressed the extreme risk aversion that investors were feeling. The flare-up of the European sovereign debt crisis – and consequent flight to safety – helped to lift bond prices. As a result, bonds dramatically outperformed equities.

The DEX Universe Bond Index, a broad measure of the Canadian investment-grade fixed-income market, gained 9.7% in 2011. Of course, it helps when 10- and 30-year yields close down to 1.9% and 2.4%, respectively. These rates offer no inflation protection to investors. A flattened yield curve, illustrated to the left, is usually a sign of sluggish economic activity.

In September, the Federal Reserve performed Operation Twist to push down U.S. long-term interest rates. It bought \$400-billion of long-dated U.S. Treasuries, financed by the sale of an equal amount of shorter-dated bonds. The Fed’s demand for 10-year Treasuries helped drive bond prices higher and yields lower. In 2011, the yield on the 10-year Treasury dropped from 3.3% to 1.8%.

Currencies:

Canada’s small, open economy depends on global growth. Last year, the slowdown in Europe and emerging market countries negatively impacted resource demand and exports. With falling demand, the Canadian dollar (as shown to the left) fell from \$1.03 in June to \$0.98 in December – down 5% against the U.S. dollar in six months. It ended down just 2% for the year. Longer term, Canada’s superior fiscal backdrop is expected to lend support to the relative strength of our dollar.

Unfortunately, conventional wisdom doesn’t apply when faced with a debt crisis overseas. Forecasters predicting a flight from the U.S. dollar were proven wrong. Despite the U.S. losing its AAA credit rating in August, investors decided that U.S. Treasuries still represented the only true ‘safe haven’ asset. In the last six months of the year, the U.S. dollar rose over 5% against the Canadian dollar. For now, the \$15-trillion U.S. national debt remains tolerable.

Commodities:

Oil prices had a rollercoaster ride last year. As shown in the chart, West Texas Intermediate (WTI) light crude oil traded between US \$75.67 and US \$113.93 in 2011. It finished at US \$99.20, up 8.1% on the year. Due to hostilities in the Middle East, near-term supply risk is expected to keep prices near US \$100/bbl. for the foreseeable future.

With the notable exception of gold, commodity prices tumbled in 2011. Prices for base metals – copper, zinc, nickel, aluminum – were pushed down roughly 20% on softened global demand.

While the prices of energy and commodities came under pressure, gold bullion bucked the trend. Yet, the price of gold itself became increasingly volatile. It began at US\$1,408 and hit an all-time high of US\$1,890 in the third quarter, before closing at US\$1,565. Measured in U.S. dollars, gold was up 10% for the year. With an improving U.S. economy and the rally in the U.S. dollar, it may prove more difficult for gold to advance. However, if the recovery stalls or investors become concerned about U.S. debt levels, gold may be able to sustain its high levels.

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