March, 2006

Global Growth versus Global Liquidity Risk (Interest Rate Risk)

Globally, equity markets continue to gain in response to reports of higher growth in the business sector that is supported by the current low interest rates environment. We have seen strong equity market performance in Asia and Europe this year. At the same time, there are increasing talks, expectations, possibilities and actual interest rate hikes in Japan, Europe, US and Canada. In US, the Fed is continuing in its interest rate hike although the weaker housing market sector may slow their pace. In Canada, March marked the fifth interest rate hike and the possibility of higher interest rates later in the year.

It is no coincidence that global growth has strengthened in recent years as real long-term interest rates have been trending to the downside. These low rates (which represent an increase in global liquidity) have primarily been responsible for the current asset inflation in the housing and bond sectors in most of the developed world. However, **this trend is set to change**; the dichotomy of higher growth rates inevitably leads to higher inflation, resulting in higher interest rates, thereby curbing the same growth that started this cycle. The end effect on the equity market will depend on what the financial participants and central banks focus on: the growth story or the removal of liquidity from the global system.

To highlight the three possible scenarios of interest rate risk (or liquidity risk), we have summarized the following:

Restrictive monetary policies. The first possibility of how excess liquidity could disappear is through aggressive rate hikes by central banks. It may take some time for global interest rates to increase, as central banks tend to take gradual steps in mop up liquidity but the cumulative effects or an underestimation of inflation risk could prolong this cycle.

Higher consumer price inflation (CPI). Another possibility of how excess liquidity could be absorbed is via a significant acceleration of global inflation. Thus far, price inflation has been controlled by globalization. Transmission of price and wage inflation has not affected the developed world due to new sources of labour supplies from the lower-cost based producing countries like China. The resulting higher CPI above the neutral level and into the positive level may keep central banks on the restrictive mode.

Bank failures and debt deflation. The third way excess liquidity could disappear is through major balance sheet destruction in the financial sector and amongst companies and private households. This could happen if asset bubbles first get pumped up, say in the real estate market, and then burst with a bang either on their own because prices got out of whack, or through a recession or an aggressive monetary tightening. In this case, banks exposed to the asset class in question would suffer and would severely restrict lending. Money and credit would shrink relative to nominal GDP as the banking system would become dysfunctional.

938 Howe Street, Suite 308
Vancouver, BC V6Z 1N9
Web Site: www.investaflex.com
Email: info@investaflex.com
Tel: 604-331-2520 Fax: 604-331-2540
Toll Free Tel: 1-888-496-3539

Although our hope is for a more balanced outcome where healthy growth continues even with higher interest rates, we would like to be prepared for the worst case scenario, which is lower growth and higher inflation. To better preserve capital, we recommend making some changes in our current income allocation.

Market and Portfolio Update

Over the last three years, in searching for higher yields on the income portfolio, we have allocated to high yield bonds, real return bonds and income trust sectors as part of our overall income strategy, and have been well rewarded for this extra risk. However, the risk/reward continuum in two of our sectors, namely high yield bonds (AIM and GGOF) and Real Return Bonds (TD), are not expected to perform to par in the future based on the following observations:

First, credit spread between the good quality and lower quality securities has been compressed to the extent that we believe that it does not give us extra benefit to be holding on to high yield bonds.

Second, while Real Return Bonds (RRBs) offer good potential for inflation protection, the real yield in Canada has decreased in the past year such that future capital gains are likely to be limited. Future gains in RRBs will probably come from higher inflation. We think a reduction in this asset case will suffice.

With the above scenarios in mind, we would like to recommend closing out all of our high yield bond allocation and reducing holdings in Real Return Bonds by 50%. The money raised will be reinvested in high yield cash accounts and quality bonds. If any of your effected funds are held under a Deferred Sales Charge (DSC) load, we will be rebating fully from our fees collected through new purchases.

Our team will be reviewing each client file and recommending appropriate changes for the rest of this month. Please keep in mind that these are recommendations only. We encourage you to use your discretion when deciding whether or not to proceed with these changes.

In the meantime, if you have any questions, or would like to discuss any of these issues with us, we encourage you to call us.

Sincerely,

Victor Whang & Malcolm Ross

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Vancouver, BC V6Z 1N9
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Email: info@investaflex.com
Tel: 604-331-2520 Fax: 604-331-2540
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