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July 2009

Global Rebalancing of Risk

There are increasing signs that global recessionary times are nearing an end. From the panic and recessionary lows of March 2009, global equities have staged a remarkable recovery to date.

In fact, as the second week of July 2009 comes to a close, several "Doomsday" economists are looking positively bullish. Highly respected bank analyst, Meredith Whitney, who predicted the collapse of many US banks two years ago, made a bullish call on US financial Goldman Sachs Group this week. The S&P500 reacted with a 7 percent rally.

Whitney's optimism is further reinforced by New York University Professor of Economics Nouriel Roubini, who correctly predicted the current financial crisis in 2006. He predicts the US will emerge slowly from recession by the end of 2009.

The new phase of economic recovery is expected to be far

below US long term potential Gross Domestic Growth -GDP of 2.7%. Increasingly analysts are leaving the bearish camp as the market improves. It seems missing out on a potential bull run is as cruel a fate as sitting through a major bear market.

What's driving the global rebalancing of risk?

First, consider the good news. While the rest of the world suffered from collapsing growth, China turned on the liquidity tap, flushing its domestic market with cheap money. The result was a second quarter 2009 growth rate of 7.9%. That was an improvement over the first quarter's 6.1% growth, confirming economic recovery is well underway in China.

Mark Mobius, an Emerging Market fund manager, said this week that China's stock market may surpass the US as the world largest by value in three years'

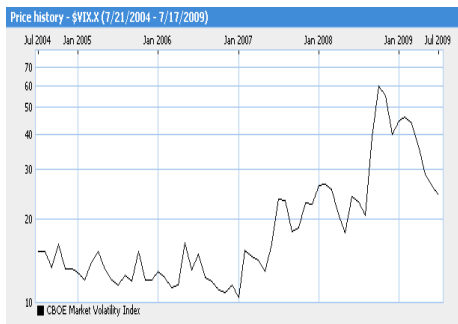
time. State owned companies are selling new shares and the nation's 1.4 billion people are putting more money into the equities market. Other Asian equity markets have staged remarkable recoveries, despite anemic economic reports.

In central Europe, sentiment is improving markedly, with a substantial easing of financing and credit pressure. In Latin America, external accounts and inflation developments are positive. Realism has returned to the Commonwealth of Independent States, former Soviet Republics, about the coming hardship and the degree of support they can expect to receive from the International Monetary Fund.

The VIX Volatility Index, an indicator of risk, is currently at 24.87, a pre-crisis level (see chart), and bond yield spreads are pointing to a normalization of risk. Anecdotal reports and evidence in Asia and Canada suggest that

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sentiments for the real estate sector have improved and the credit scare and panic of the first quarter 2009 is over. Even US new home starts rose in June, helping to ease the pressure on American housing related stocks.



One of the major factors in the global recovery is the “rebalancing act” of global trade. The world is now so connected, particularly in the case of China-US trade relations.

Impact of the current scenario on future recovery

Traditionally, the US ran a large trade deficit with other major exporters, such as China and Europe. The American economy was supported by huge domestic consumer sector demand in an era of easy credit and massive housing price gains. When crises such as recession, the Asian economic crisis, and the Tech bubble erupted in the past, US consumers led the recovery as they continued in their buying and spending ways.

This time around, US consumers have been badly hurt by the “financial meltdown” and are now

forced to save more than they spend. Losses in the stock market, real estate values and jobs are creating a sense of new economic reality, forcing Americans to dip into their savings to fund retirement.

Thus, the prognosis is for a slow upturn from recession in the US and it's trading partners. As China rapidly accelerates its own domestic demand and becomes less dependent upon export - led trade with the US, it can provide stability to the world financial system. The same argument applies to the other export dependent Asian nations.

Another important factor is the extent of US economic fiscal and monetary stimulus. For almost a year, the US short term interest rate, or Fed Funds rate, has been kept at zero percent. The US government implemented a USD 1.75trillion asset purchase plan, which made many non-US investors such as pension funds nervous about the US “inflating” their way out of their problem by printing more money. If the US government can refinance its debt without causing a run on inflation either domestically through new savings by the private sector, or through their non-US counterparties, the prospect of an early recovery seems more likely. In fact if the US Government embarks on a second round of stimulus, it will further ensure that recovery will take root. In the past, however, stimulus has been applied in reaction to further

deterioration of economic factors, rather than proactively.

Going Forward

So with the recovery in sight we are nearer to the end of the tunnel. What are the investment implications and strategies going forward?

Just like the assessment of the growing balance of risk in the global markets, investors should look into their degree of exposure to the market and take action to rebalance their risk. For those who were heavily exposed in the equity market throughout the market rout last year, this is an excellent opportunity to rebalance/trim equity exposure if the market rises further. To those who have mostly income exposure, it is time to add an increment of growth to their portfolios through higher risk classes such as high yield bonds, small cap and global equities.

In our opinion, the equity market for the next few years will be more volatile on the ups and downs, its trading pattern is likely to be more like Japan in the 90's or the United States in the 1930's (see charts): trapped in a broad 50% range either side rather than the perpetually rising equity market usually seen on an Andex Equity Index chart.

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In this environment, a “buy and hold” strategy may not be the best in the end. In fact the buy and hold strategy has proven to be a weak model based on the last 10 years experience, where losses have exceeded more than 50% in two occasions. Adjusting one’s risk exposure to equities becomes more critical to successful investment management.

At Investaflex, we’ve spent a great deal of time updating and improving our risk/return modeling, and we’re proud of the returns we’ve realized for our clients. A typical Investaflex client in a balanced portfolio achieved an annualized return of 5.6% over the past six years. Compare that to the five year performance of the 639 Balanced funds listed on GlobeFund. Less than ten percent achieved as high a return.

We’ll be contacting you in the coming months to update your PRISM risk profile and KYC- (Know Your Client) declaration. These documents form part of the overall process of determining investment products suitability based on one’s level of personal risk tolerance.

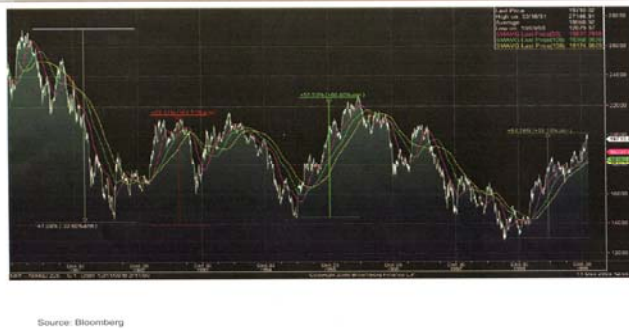
So stay in touch, and if you need clarification on any of the points discussed above, or have any questions, please call our Investaflex Team.

Thank you.

U.S. in the 30’s



Japan in the 90’s



Victor Whang
604.331.2524



Malcolm Ross
604.331.2521



Violet Smith
604.331.4465

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