

Mutual Success

Your Fund of Information



March 2009

Opportunities in Unthinkable Times!

The global economic Gross Domestic Growth (GDP), a measure of economic health is expected to see a rapid deceleration in 2009. Expected GDP growth for 2009 for US is -3.3%, Japan is -6%, Europe is -3.3% and Latin American is -4.0%. With the exception of China, India and a few lucky ones, GDP is likely to contract in almost every country around the globe. There are many reasons for the contraction, but the four most important factors are:

1) The world economy is in its deepest and most synchronized post war recession.

2) We have the largest synchronized global drop in asset demand since World War II that affects almost every major class of assets (stock, bond, real estate, commodities, etc).

3) We have witnessed a large amount of wealth destruction (household, corporation, pensions and national wealth) due to this deleveraging process (for the past 1.5-2 years).

4) This downturn is comparable to the last depression in the 1930's. The seriousness and severity of this situation has prompted world

governments and central bankers to take continued and sustained actions to shore up confidence and lessen the impact to this downturn. Interventions by most governments take many forms but are basically in the following four categories:

1) Holding a loose monetary policy (cut interest rate).

2) Fiscal spending (tax cuts, increase infrastructure spending - building more roads and highways etc.).

3) Quantitative Easing (QE) or some say "printing money" via keeping short-term interest rate at zero/near zero, government buying of long-term government securities/bond, devaluation of currency.

4) A host of other non conventional forms of Credit Easing (CE) and bailouts (e.g. AIG, CITI bank, TARP, TALF, etc).

Just over the last few days, the US Federal Reserve Department (called the "FED" in short) has expanded their balance sheet by more than another \$1 trillion to buy longer term government and mortgage securities flattening the yield curve or long term cost of borrowing. We think the latest

action was good but still not enough. By the time there is a turnaround, (2010, 2011?), we think the Fed will have expanded their balance sheet by \$4-5 trillion in order to avoid depression. If the Japanese real estate and stock bubble burst is of any guidance, their government's balance sheet went from 40% Debt/GDP to 200% Debt/GDP, from start to finish in about a decade. That period in Japanese history is well known today as "the Japan lost decade". We do not think the US Government will want to let this situation deteriorate into a long-term problem. We think the FED are far more aggressive in their actions than the Japanese, therefore the turnaround would be faster than 10 years (perhaps in a couple of years). In the meantime, the markets will have to struggle through the tug-of-war between Government's actions versus investors/consumer confidence.

We are at last beginning to see some short-term positive response to the latest policy action taken by the FED in terms of investors' risk appetite into the riskier asset class as seen with a quick recovery in the stock market from the bottom. This follows from the announcement that US FED will spend \$300 billion to buy long-term

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government bonds and mortgage securities. There is an ongoing debate on whether the current action by the FED and similar action by other central banks (SWISS and UK) are effective or sustainable. We all now know that in order for the world to get out of current trajectory of collapse (this path of global deceleration, deleveraging and depression), the government will have to step in aggressively. They will have to become the lender of first and last resort. They will print as much money as possible and as fast as possible (until the forest runs out of trees?) to re-inflate the economy. Failure to do so means tremendous debt destruction which means more defaults, which also means a prolonged period of jobs losses, loss of corporate health and loss of asset (real estate, stocks, etc) value. Therefore the Government is committed to re-inflate the economy, hoping it will result in the form of real growth, but if not they will engineer this growth through inflation.

Another upcoming important event to watch will be the G20 meeting on April 2, 2009 when central bankers and heads of governments from a Group of 20 nations (G20) will come together to work on finding a solution to our economic problem. Our current economic world model that is largely dependent on the US as the engine of global growth is broken. For a long time, the world depended on US and the G7 nations. They have been and are core centres of influence in our world economy, acting as a major trade centre. They also act as the defender and rescuer of the world financial system. In the past, most problems happened outside the core, in peripheral economies like the LATAM (Latin America Debt Crisis), Emerging Europe (like Russia Ruble Crisis) or Emerging Market (Like 1997 Asia Crisis) and G7, working through International Monetary Fund-IMF, World Banks were usually the rescuer. Now the G7 themselves has become the cause of the current problem (emerging from US) that affects the rest of the world; they will have to bail

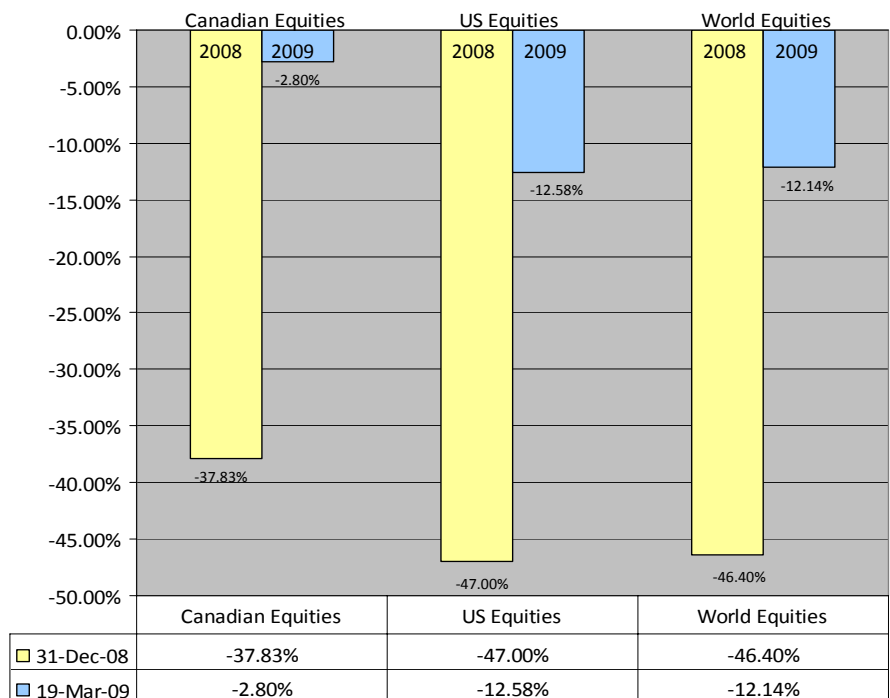
them/us out of this situation. Therefore, we will have to watch what other possible measures are likely to come from this gathering later this month.

Investment Review & Recommendations:

In hindsight, we have been validated for taking a pessimistic view last year as seen from our past newsletters and update on investment. We recommended trimming risky assets (equities) as the market fall off from last two years. While other firms have pursued a "buy and hold" strategy, we advocate an active asset allocation strategy. In the last 10 years, in applying a buy and hold strategy, an investor would have to sit through two major bear markets that had a loss of more than 50%. Clearly the approach to just buy and hold and hope for the best in the long-run has not worked. Individual stocks like Nortel, AIG, or Citibank highlights this. We have

reviewed a number of prospective client portfolios that contain more risk than their risk tolerance would deem appropriate and have seen the destruction of household wealth. We also know that as economic uncertainty increase, portfolio volatility and hence risk increase. However, as volatility increase, the appetite for risk declines resulting in an increased divergence between individual's risk tolerance and risk in their portfolio. We know that we can only manage risk to comfortable levels by actively adjusting portfolio allocation during such times, hence our approach of active asset allocation. We would not have recommended taking any risk that is the maximum equity/growth/risky asset class allowable set out the initial strategic asset allocation based on the initial determination of our clients' risk tolerance. Most of our clients who took our recommended actions during this period have suffered much less losses than would have. Most clients have only a small risky (equity) position and more cash or fixed income type investments on their portfolio this year.

Canadian, US, and World Equities Return for 2008 and 2009 (March 19, 2009)



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Because of the turmoil and volatility in the economic situation, there exist tremendous opportunities in these kind of market. Yes, opportunities. The late and great investor Sir John Templeton has a "buy when there is blood in the streets" philosophy. We think that there are opportunities if only there is cash on the sidelines and our strategy for dealing with cash, mortgage funds, fixed income fund and equity fund is as follows:

1) **Cash** - As central banks cuts interest rates to almost zero, money market and short term cash rates are falling to close to the same level. Our intention is to place as much money as possible with those that still offer a positive return.

2) **Mortgage Funds** - As the central bank tackles the housing and credit crisis by cutting interest rates, mortgage funds continue to do well. That is because they still hold mortgages (vary from 1-5 year term) that are still paying them above 5% for a 5-year term. Hence as mortgage rates drop (5-year rate currently close to 4%), the fund will accrue capital gains and still collect the higher interest. We think the opportunity still exist at least till the end of the year when we believe the mortgage rates will bottom out.

3) **Fixed Income** - As interest rates drop, opportunities exist in the bond market as they still command an interest rate risk premium above risk free interest rate to hold cash. With possible long-term bond yields falling off, bond prices remain supported for at least the next three to six months. Downside risk will be the possibility of more corporate failures (for poorer quality corporate bonds) and inflation rising too soon. However, we will recommend inflation protected bonds or real return bonds when that time comes (we first have to avoid going into deflation for now). High yield bonds (poorer credit quality bonds) are another opportunity to take market risk without buying into equities (they yield above 20% per annum) as the

market recovers, but we are still weary of default risk.

4) **Balance funds** - We have traditionally not recommended balanced funds as we feel that the nature of our clients' portfolio resembles a balance fund. We have also traditionally recommend managed funds (to add value), however, we are now recommending AGF Canadian Balanced fund as a conservative approach/strategy to enter into the market. Their philosophy of investing is similar to ours and they have a quicker access to buying up to 60% of their fund into equities when the timing is right, a decision that we will leave very much to the fund manager's (Christie Hugh) skill and good judgment.

5) **Equity Funds** - As seen from the above rates of return data for 2008 and 2009, Canadian Equity returns compare much more favorably to US or World equity returns, we believe that this relationship will remain (e.g. Canadian market to perform slightly better than most equity markets - relatively speaking). One thing we learned from last year was that as market correlation is greater in a down market than in an up market, which is to say that whether one is in foreign equity or domestic equity, all markets comes off in about the same time with slightly different degree. The degree of difference is accounted for by the extent of diversification that one gets from the relative currency fluctuation and hence, the diversification is due mainly to a currency play. We still think Canadian banks and currency will remain one of the strongest in the world at this stage and due to a higher component of resources and oil in our index, they are the sectors that usually lead in any recovery. The risk of US Dollar devaluation also bodes well for bringing more money back to Canada. Progressively, we have also been looking into using passive index funds to implement our active asset allocation strategy.

6) **Other Specialty Class (GOLD)** - We have recommended Gold funds last year but had to sit through high volatility as the gold price (went mostly higher) and gold stocks decoupled (went mostly lower). We also learned that the best way to invest into this special class is to perhaps own physical gold bullions. As the financial market experienced an almost systemic breakdown, gold remains a safe haven hedge. In periods of turmoil and war, people traditionally looked towards holding some gold as protection/insurance/hedge. There is usually a very small avenue to buy gold bullion or bars. However, there is now opportunity as Sprott Asset Management has recently launched (as of 17 March 2009) a pure bullion fund that invests mostly in Gold bullion and Gold certificates. We will look into the possibility of using such a fund. Another reason is that since early March, the Swiss National Bank started to manipulate and intervene in the international currency market by selling their Swiss Francs currency. If the rest of the world were to follow the Swiss's actions - an example of currency devaluation (bearing in mind that the current currency system is a floating exchange rate mechanism), the risk is that we may start a process of competitive currency devaluation, which in our opinion is a race to the bottom, a debasement of paper money (making them worth less compared to the price of hard assets like Gold or other natural materials and resource).

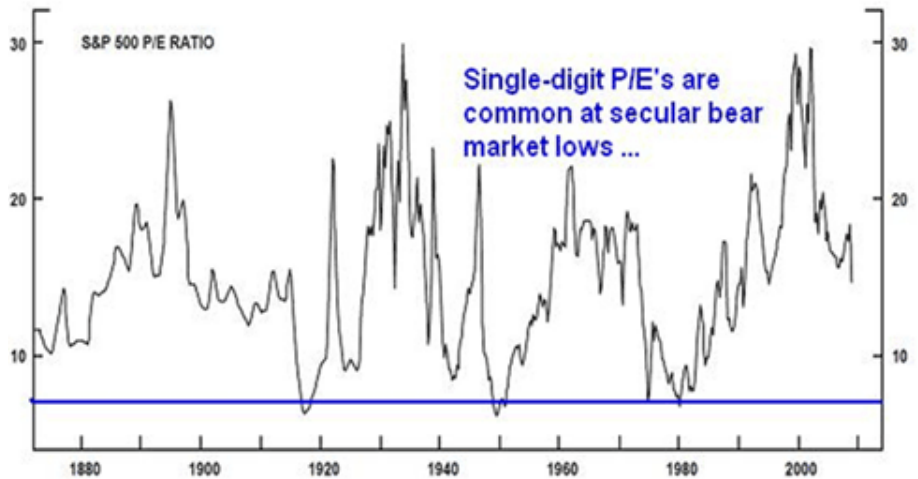
7) **Oil, Materials and Resources** - Raw materials saw a tremendous price destruction last year as prices laterally collapsed as seen in the Commodity Research Bureau (CRB) Index. At some stage last year, commodities prices were supported by a weaker US Dollar (since they are mostly priced in US Dollar terms) and fear of inflation. However, the reality was that the opposite of both happened, a stronger US Dollar and a fear of deflation. So prices fell to 5-year lows and most have fallen 60-80% from their all time highs. However, unlike other business, there is always a

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breakeven cost of extracting oil or mining industrial raw materials. Hence, there is a good chance that they would see a bottom forming earlier than other sectors and subsequently when the economy turns around, even if it is just a small growth, commodity recovery will lead the way.

8) **Other Alternatives** - We are also looking into other alternative areas such as using insurance term and segregated funds that offer a guarantee.

Like everything else in life, we recognized the importance and wisdom of good timing and judgment in every decision. While in hindsight, we have done better than the market, we are also aware of the fact that if there is a quick and unexpected market recovery (which we do not believe is the case at this point - maybe a 1/5 chance), we may miss a good buying opportunity. We think that the market is still in a stage of working out the excesses and there is a 4/5 chance we could see more downside from here. While we think the risk for further decline still outweighs the potential for gains, we know that markets do not move (come down or go up) in a straight-line. There will be opportunities as always for both. Regardless, equity markets will ultimately seek to find their own bottom. So whether the stock market carnage stops at 50%, 60%, 70% or 80% from the start of the decline, nobody knows. Therefore, we recommend a "scale down buying approach based on price" strategy on top of using balanced funds. Technically and historically, as stock prices decline, the valuation based on Price/Earning (P/E) ratio (currently above 12 times) gets cheaper and more attractive (P/E ratio of 12 times means it takes 12 years to recover one's investment capital based on today's paying price). The period of 1929-1933 as well as similar periods when P/E approach 5-7 times, have been great buying opportunities, resulting in tremendous compounding gains years down the road. We will not



Source: Bank Credit Analyst, February, 2009

know how, when, and if P/E will approach those levels, therefore we recommend progressive buying as P/E approaches these levels up to one's risk tolerance. Other than looking at technical price levels, based on the macroeconomic, we think that the first and second quarter of 2009 will see a lot of negative economic news in terms of plunging production, export, unemployment, GDP growth, consumer confidence etc. However, improvements are not always in big jumps but most often in baby steps. Therefore, if we see an improvement even just at the margin (month to month, quarter to quarter) in terms of economic numbers (exports, etc), that will be a time to start increasing exposure. Of course, concerted political actions such as those which may be agreed at the G20 meeting may provide further impetus.

friends or family who are distressed with their current investment position and are seeking a second opinion, we are most willing to do an initial review of their investments and other financial plans at no cost if they are willing to be of service.

In the meantime, please feel free to call any one of us here at Investaflex/Sterling Mutual Inc. if you have any immediate concerns. It has been a pleasure to be of service to you. Thank you.

Best Regards,



Victor Whang
604.331.2524



Malcolm Ross
604.331.2521



Violet Smith
604.331.4465

Lastly, thank you for your continued trust and confidence in the Investaflex Team / Sterling Mutuals Inc for managing your assets in these uncertain times. We also appreciate your patience while working with us in dealing with this volatile market. We will review each client's financial and investment plans and will set up appointments to meet with each client individually. Ironically, it is in the down market that we work even harder and put in greater effort to try to minimize the effects of the fallout. If you have

Sterling Mutuals Inc. - Vancouver Branch
308-938 Howe St. Vancouver, BC V6Z 1N9

Toll Free: 1.888.496.3539 Tel: 604.331.2520 Fax: 604.331.2540

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