

Q2.09 – ‘March’ing Along, for Now

17 April 2009

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- We were very successful in the quarter at buying on oversold conditions and using the options market to hedge downside as the market rallied.
- Market correlation giving way to gradual decoupling.
- Key issues: economic data, trough spotting, Emerging Markets

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- Bearish to Bullish in a Flash - sentiment indicators for US markets are flashing warning signs. This is a cyclical market rally, not a new secular bull.
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- While we have emphasized the need to be cautious in this Strategist, we continue to invest offensively.
- The speed with which market psychology has been changing warrants a watch on the broad trading trends
- For the financial library: The Pendulum Never Stops in the Middle

IN A PICTURE



Source: New York Times

Overview

This quarter was characterized by the strong market moves of March which recovered from a very oversold position. We are pleased with the portfolio results as our areas of emphasis experienced moves better than the market averages and have positive returns for the year as a whole. While encouraged, recent sentiment indicators have whipsawed from overly bearish to above-average bullish. We use company fundamentals as our primary decision tool but continue to monitor market psychology as indicators of opportunity – both to realize gains and to buy at discounted prices. We are not expecting a new secular bull rally to materialize and continue to position portfolios with a secular bear market as the base case. We were very successful in the quarter at buying on oversold conditions and using the options market to hedge downside as the market rallied.

Quarter Highlights:

The sources of portfolio performance so far this year have been a result of overweight positions in Emerging Markets, successful sector positioning, and hedging.

- * Emerging Markets positions posted a gain of over 15%.
- * Semiconductors were strongest and our holding in Taiwan Semiconductor beat the sector, climbing 22%.
- * Covered call writing added an average of 9.6% downside protection.

(Risk) "is not being repriced, it is repriced, ...you're getting paid for taking risk. For the longest time, you weren't." Prem Watsa (Canada's Warren Buffet)

DIRECTION . our big picture views

'March'ing Along, for Now

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Sources of Outperformance

The sources of portfolio performance so far this year have been a result of overweight positions in Emerging Markets, successful sector positioning, and hedging. Emerging Markets have strongly outperformed developed market indexes so far this year. As a proxy, the iShares MSCI Emerging Markets fund is flat year-to-date. Looking at the portfolio, our Emerging Markets positions have posted a gain of over 15%. Within Emerging Markets, the strongest performer was Chile at a gain of 16%. Our holding in Chilean company SQM provided a 17.5% return. These examples confirm our stated strategy that buying broad index funds is not the course of action but that high quality stock selection is.

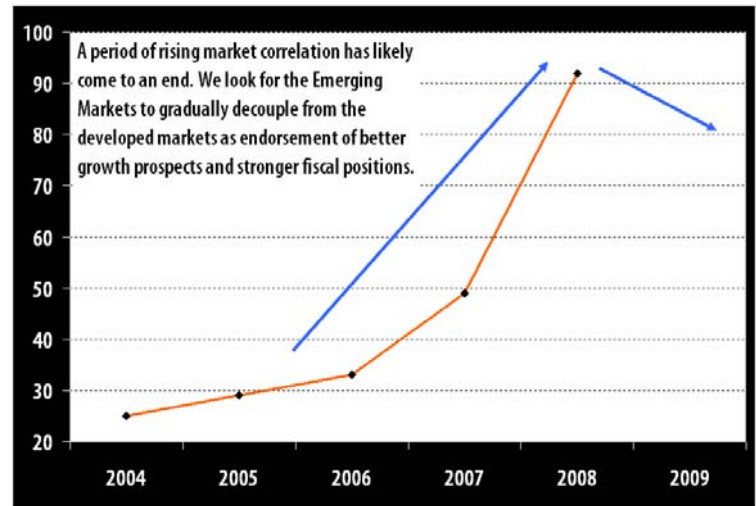
Drilling into sectors, Semiconductors were strongest, posting a gain of 13% in the first quarter. Our holding in Taiwan Semiconductor gained 22%. On the flipside, one of the worst performing sectors has been infrastructure. Although this sector has started to come to life as credit markets have settled and some flattening of the economic decline appears to be occurring.

Gradual Decoupling

We have emphasized our view that the Emerging Markets are positioned to gradually decouple from Developed markets. A quick review of rolling 10-year correlations shows a steady climb to near-perfect correlation with the S&P 500 and other global benchmarks. However, events since the beginning of

2009 are very different. Figure 1. points this out and we believe the characteristics of better growth prospects and stronger fiscal positions will encourage gradual decoupling of Developed and Emerging Markets to play out.

Figure 1. Correlation between MSCI Emerging Market Index and the S&P 500 (10-year rolling average at each year-end)



Source: Morgan Stanley

Key Big Picture Issues

So far in April, markets and holdings have been testing thresholds in the face of a decidedly mixed bag of economic data and earnings reports. Where most of the data are confirming recessionary conditions, markets appear to be pricing in stabilization. We believe a period of consolidation of recent gains is required but do not believe they will return to March lows. Our short-list of key big picture issues include:

1. Economic data that continue to confirm what the markets priced in at the lows in March. Rising unemployment, slowing retail sales, limited inflation are all confirming what has already come to pass.
2. Trough spotting is the new stock sport. A quote from a preview on industrial company earnings "The question everybody's trying to answer is when do we reach the trough? Is it late in 2009 or will it be 2010?". Quite frankly, we're not trying to predict the turn in earnings. Instead, we are conservatively evaluating company earnings with the downside in mind and simultaneously evaluating where holdings sit technically the next leg in this secular bear market.
3. Watch Emerging Markets for continued signs of gradual decoupling

CONFIDENCE. our execution

Bearish to Bullish in a Flash

We are encouraged by the recovery rally. However, the speed with which sentiment has changed from bearish to bullish is astounding but does raise some red flags. Sentiment has swayed from 70% bearish in early March to a current reading of above-average bullish (AAII weekly survey). This is highly emotional and could swing quickly in the other direction in pullbacks. As a result, at this juncture we are more inclined to buy on those pullbacks.

As we have indicated, our execution in the first quarter resulted in a year-to-date return in positive territory. This is largely attributable to playing to a contrarian strategy that found us buying positions as sentiment was hitting the 70% bearish level and protecting returns as bullishness returned to the market. Global indexes were strong, led by Emerging Markets and our positions in these areas were key performers. Brazilian Government Bonds performed well and water utility SBS has been exceptional. We continue to favour Brazil as a region but think a pullback of 10% would be healthy and offer buying opportunities in equities within a continuing secular trend.

In our latest Insight, we highlighted covered call writing as a strategy to protect downside and create additional income. To review, covered call writing involves the sale of a call option. This generates tax-effective income and effectively lowers the cost base of the original holding. At the same time, we sell options with prices that match our estimate of fair value so that if the stock price runs through that level, we would be selling the holding at what we consider full value or better. Figure 2. gives a sampling of the impact. The important part is the ratio between potential upside and downside protection. These cases illustrate attractive combinations.

Figure 2. Covered Call Writing

	Call income per share	Protection as % of stock price	Potential Return [^]
ABB Ltd	\$ 1.80	12.9%	20.5%
SBS (Sao Paulo water utility)	\$ 2.60	11.8%	25.6%
SQM (Chilean specialty commod)	\$ 3.37	10.6%	20.9%

[^] Call income plus capital gain vs. share price at time call was sold.

Source: Sandstone

The Forward View

We expect Emerging Markets, technology, and commodities to lead, whereas healthcare and consumer staples offer stability in corrections. Recently, healthcare and staples have lagged.

Earnings Season

With earnings season kicking off this week, management guidance will be of particular importance. Our expectation for earnings season overall is as follows:

- similar to the economic reports, we do not anticipate glowing earnings. However, we do think that in some cases, estimates are overly pessimistic. This is the single factor that could extend the rally through earnings season.
- expect continued volatility around the days companies are reporting – with our focus on fundamentals, volatility usually means opportunity
- watch for hedging opportunities for those companies we expect to post high quality results. If bullishness extends through earnings season, we will compare what the options market is providing to our revised fundamental view

On a company-specific basis, here is a sampling from holdings that will report results over the next two weeks:

Taiwan Semiconductor - March sales were better than expected on the back of strong smartphone demand as well as netbooks.

GE - watch will be on loan losses but credit conditions have improved all the while the core growth businesses continue strategic investment in lithium-ion battery technology, smart grid, global infrastructure. (reported today above expectations)

Swiss week! ABB, Novartis, Nestle. Expect foreign exchange moves to be important. ABB a top global pick for power infrastructure and contract wins confirm that. Novartis is attractive value given growth prospects and comparative valuation in sector. Nestle has a strong global franchise with emerging market benefits.

New Oriental Education – share price may have gotten ahead of itself at this stage. Near-term call option provides potential cushion to a pullback.

Keppel Corporation – a proxy of the health of the global oil industry but other divisions are growing. The Company recently signed a monster (US\$475 million) waste-to-energy contract in the UK. This is a big positive and an early sign of how Keppel will participate in global fiscal project support.

CONFIDENCE. our execution ...

China Update

There are many opinions on China's chances of sustaining its GDP growth record in the current environment. The skeptics refer to a high reliance on exports and excess industrial capacity as reasons China will slow dramatically. As we've been reinforcing so far this year, we are more constructive. The primary reason is we believe the political structure lends itself well to having an impact on economic growth. Its 5-year plans are targeted at sustaining economic growth as the key to continued stability. The policies announced this year are consistent with combining social improvements with economic growth, most particularly in their rural regions. A New York Times article this week supports this view ([Growth Spreads From China's Coast](#) - click for full story). A sampling from the article illustrates the positives of the government's "Go West" policy which began in 1999 but has come to the fore today. As the article indicates, the domestic and rural focus could add 2.5 percentage points to GDP.

So it is that the fastest-growing part of China has been resource-rich Inner Mongolia. Between 2003 and 2008, the region enjoyed average growth of 19.7 percent a year.

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Worried by the yawning wealth gap, Beijing introduced a "Go West" development policy in 1999 that has gathered momentum since President Hu Jintao took power in 2002.

Apart from spending more on rural infrastructure and subsidies, the current leadership has abolished the centuries-old agricultural tax, made compulsory education free in the countryside and set up a rural medical insurance scheme.

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Based on the rousing start to a three-year plan to subsidize the purchase by country folk of major appliances like refrigerators, Glenn Maguire, a Société Générale economist, calculated that 600 million home appliances worth 1.6 trillion yuan, or \$230 billion, could be sold in rural China by 2012.

Over all, rural consumption should add 2.5 percentage points to growth every year between now and then, he said.

from *Growth Spreads From China's Coast*

SHENZHEN, China — Like a spreading ink blot, messy and uneven, economic growth is seeping inland from the coastal provinces that have been in the vanguard of China's phenomenal growth over the past 30 years.

The shift, which has rough parallels with America's westward migration in the 19th century, has the potential to narrow the noxious income gap between China's vast, neglected interior and a relatively well-off seaboard that has hitherto attracted most of the investment by the Chinese government and foreign companies.

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Consider some recent statistics:

Urban fixed-asset investment in eastern China rose 15.4 percent in the first two months from a year earlier; in central and western China, it surged 34.3 percent and 46.7 percent, respectively, according to the National Bureau of Statistics.

Business confidence in the west was much stronger than in the east in the first quarter, according to statistics office surveys released last Thursday.

INDEPENDENCE. our take on things

Overall on Offense

While we have emphasized the need to be cautious in this Strategist, we continue to invest offensively. The economic data and select poor corporate results will likely put a cap on the height and length of the recent rally. Sector and individual stock selection will determine outperformance.

There are growing signs of recovery in risk appetite (not necessarily economic data) that have encouraged the market along that include:

- Large pools of independent capital have been raised to buy undervalued private equity vehicles.
- Large mergers and acquisitions have been announced. These have been concentrated in the commodity space but have also included some mega-cap healthcare companies. We are less convinced of the benefits of this latter group because they are combinations of low-growth companies and could be viewed as an effort to smooth earnings by cutting costs.
- The Canadian market has also seen very active capital raising that, while concentrated in commodities, is reflective of efforts to clean up balance sheets and/or raise a war chest to pursue growth. This is in sharp contrast to the European and UK markets.

One major factor could sustain the rally through this current earnings season. Analyst estimates currently reflect a large degree of pessimism. The estimate for 2009 S&P500 earnings has been revised down by 32% since the beginning of the year. Forecast history has shown that analyst estimates go from way too high to way too low through the cycle. If we do get positive surprises to marked-down earnings, then conditions improve and the confidence of the market increases. It will be important to identify companies with a positive earnings base and positive improvements to separate those companies who will excel going forward, not just show improvement in losses.

We conclude by saying that while our primary focus for evaluating investment opportunities is fundamentals, the speed with which market psychology has been changing warrants a watch on the broad trading trends. Highly volatile and

emotional markets are the order of the day. Thank you for your patience and support through this wild ride.

We came across a piece we thought we would share with you – something to stick in the reference library as we go forward. We hope you enjoy it.

The Pendulum Never Stops

By Dan Richards

April 7, 2009

Occasionally, something we hear sticks in our minds and stays with us.

When I was at the Harvard Business School in the 1970s, my finance professor used a phrase that I often find useful in conversation with clients and investors - especially in markets such as we're in today. That phrase: "The pendulum never stops in the middle." This professor was one of the big names in the field - he consulted with many of the Wall Street firms and was frequently quoted in the press.

He used this phrase in the context of market valuations and market sentiment. He talked about the historical reality that markets inevitably swing from one extreme to another, from periods of outlandishly elevated valuations to ridiculously beaten down levels, and from periods of unquestioned euphoria to absolute pessimism.

"The pendulum never stops in the middle" applies in lots of other cases.

Look at today's attitude to risk and leverage, especially as it is portrayed in the media. Companies that were fiscally conservative and didn't borrow to the hilt to boost profits were criticized for failing to maximize shareholder value. (The most popular article in the online New York Times recently was a piece laying out Canadian banks as the model for the global banking system - a notion that six months ago would have been completely absurd.)

This is also reflected in expectations of oil prices. A year ago, the "peak oil" theory held sway and demand from China and India was going to push oil to \$200 by year end. Today we've begun to hear about the "peak demand theory" - the view that demand for oil peaked last year and we'll never, ever see demand at that level again. With the benefit of hindsight, the first forecast is now clearly absurd – and almost certainly the second one will be equally so.

The Pendulum Never Stops cont.

Recall all the investment fads and “flavor of the day” investments. And think about the wild swing in consumer sentiment toward appropriate spending habits - from the norm of lavish expenditure to “the new frugality.”

My finance professor’s key point was that while the stock market may be efficient and rational over the mid- and long-term, in the near-term the “swinging of the pendulum” creates terrific opportunities for companies and for investors who can maintain their perspective.

That was true thirty years ago ... and it’s arguably even truer today.

The first truth is that what really drives markets to their extremes are the twin emotions of greed on the upside and fear on the downside. Both can be hugely costly – and it takes real discipline and resolve to withstand the forces of those emotions as the pendulum moves through its arc.

You can refer to the second truth - the costliest advice for investors is “it’s different this time.”

Seasoned investors know it’s never different. As just one example, those investors who listened to market prophets saying that the historical rules didn’t apply to tech stocks in 2000 and resource stocks a year ago ended up paying a huge price.

Chances are those investors who are taking counsel from the most extreme voices of doom today will likely pay a similar price in wrongheaded investment strategies and missed opportunities.

We may not be all the way to the extreme of despair and pessimism, but we are almost certainly well past the mid-point. We’ll look back years from now and recognize that the drastic shift in sentiment has created significant value for those bold enough to look past the swinging of the pendulum.

Disclosures

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ABB, GE, Keppel Corp, New Oriental Education, Nestle, Novartis, SBS, SQM, Taiwan Semiconductor

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