VIS A VIS

INVESTMENT COUNSEL INC.

July 9, 2007.

Client communiqué: Portfolio Dynamics

Summary of Market Metrics *Currency, is still a big issue.*

In North America, the Stock Markets performed well (also worldwide). As a snap-shot, the Toronto Exchange was up 7.7% this year and the average of the American exchanges was up about 7.1% in local currency. The US dollar's drop during the 2nd quarter was again material and reduced valuations of all US assets by 9% as measured in Canadian dollars. The pressure for Interest rates to increase and anecdotal *inflationary* inputs have manifested into flat to negative returns on most Domestic Bond portfolios. (Fixed-Income Allocations at Visavis have not been affected in this regard and are typically in interest bearing cash positions or hold short-term bonds).

Below is a Table of Stock Index returns that we have provided to you within your quarterly portfolio tabulations you have been receiving. Below we elaborate on its pertinence and the impact of its dynamics.

During the second quarter of this year, the Stock markets shown here (and others worldwide) performed exceptionally; up about 7% on average during the 2nd quarter. For the full year-to-date, this average was +7.3% in local currency, as shown below.

What is also noteworthy and remarkable is the further appreciation of the Canadian dollar against the US$ +8.9%.(rather, Depreciation of USD against the Canadian dollar is perhaps more illustrative of what has transpired.)

Result? If US stock index returns were only matched, i.e. plus +7%,(in most cases they were surpassed), then a US Equity portfolio would have experienced a negative 1.6% return during this exceptional 2nd Quarter. This is because we necessarily measure portfolio-value and portfolio-returns in Canadian dollars, for our Canadian Investors.

29-Jun-07		Visavis Benchmarks				Year to Date	
INDEX--RETURNS YEAR-TO-DATE	*YTD	1Q'07	2Q'07	3Q'07	4Q'07	$can	local
dj	-1.7%	-0.9%	8.5%			-1.7%	7.6%
s&p	-3.1%	0.2%	5.8%			-3.1%	6.0%
tse	7.7%	2.0%	5.6%			7.7%	7.7%
nasdaq	-1.5%	0.3%	7.5%			-1.5%	7.8%
NB * YTD % change in $ Can		simulated equal weight return		0.4%		0.4%	7.3%

A Canadian stock portfolio, containing an equivalent and <u>dis</u>proportionate weight in Resources (45% in Oil, Gas, Mining, Materials) would have better matched the TSE(TSX) returns of +7.7% shown in the Table provided. We question the wisdom of having ones savings dependent in this fashion and proportion, on the fickle and elusive fortunes of mines and oils. (we maintain and encourage a more modest exposure to these sectors)

The 'Simulated Equal Weight Stock Index Return' that we typically provide to you, is a useful relative benchmark with which to gauge your own Stock Portfolio results. Year-to-date, stock portfolios that were invested in these particular indexes, and in these proportions would have experienced a <u>plus 0.4% return</u>. So what happened to the exceptional plus 7% returns we highlighted earlier? US dollar depreciation expunged about 9% of these returns. (Maintaining USD denominated investments is still recommended and explained further on page three of this communiqué)

The recent increase in interest rates worldwide has resulted in negative returns for most Bond Portfolios. The Fixed income component for most of our clients represents the majority of their portfolios. As we have typically held very short maturities, or otherwise, Cash (earning about 4% pa), we can now opportunistically start to slowly deploy these liquidities in Canadian Government Bonds. At what interest rates? Currently, risk-free rates are around an unimpressive 5%, but seem to be increasing.

Managing investment Risk is one of our biggest preoccupations. This means preserving your hard-earned capital. For most of the investment community, measurements of Risks have typically been accurately quantified only <u>after</u> 'the event.' Who does not, now know, about the DOT.Com bust? The US$ Depreciation? The Bond Market collapse? The latter, has not transpired yet but is an increasingly credible expectation. Why? Bond values have never been so high the last few decades (nor yields so low) and are prone to a material adjustment. Recent difficulties in the Housing and Mortgage markets and CDOs are perhaps symptomatic of upcoming turbulence.

The *phantom-liquidity* that has been engineered and reengineered by Governments and Industry is fickle, unreliable and unsustainable long-term. As this deemed excess liquidity unwinds, interest rates will increase smartly and all asset values will be affected; in most cases, adversely. Borrowed money must be paid back? Will the Hedge Funds, Private Equity Buccaneers and Structured-note purveyors have the money to repay? Perhaps another Banking fiasco may be developing; We are due; Every 10 years is usually the norm{OIL, LDC(now emerging countries),S&L, R/E, Asian Crisis…}

How best to navigate your investment portfolio through the complex and brittle financial system? Investments should be predicated more on "Return **<u>of</u>** Investment" rather than "Return **<u>on</u>** Investment." Quarterly returns and Annual returns are very important. What is more important is that Capital also remains intact. Currently, ideal financial flexibility, in our view, can be attained with 40-55% in Equities, and balance in shorter-term government bonds and Cash. [For investors who have most of their earning potential ahead of them (youngsters), one can maintain a more aggressive investment profile, i.e. more in stocks, R/E, alternative assets]

<u>The demise of the USA and the US$:</u> We had pointed out in a prior communiqué that during the last Presidential election, the rest of the World was also voting *in* the USA, but with their currency. Selling of US dollars has been a norm the last few years. Geopolitics

is one reason. Another is the seemingly unstoppable increase in spending by the USA (the twin deficits). Due consideration to this Deficit provides a more palatable explanation and necessity for such massive spending.

China and India are evolving into two of the World's major Economic engines. How did this occur? Who financed this growth? Well, much money was required as well as the determined willingness to bring about such an occurrence. Europe neither had the liquidity depth nor the willingness to finance the growth of these two nations. The USA is the only economic powerhouse that has the willingness and financial prowess to bring China into a consumer-centric world. A payback for the $trillions invested is expected to be generational. The serious distraction we still hold with this best-case scenario is that China is still a Communist Country and India is still not a fully accessible economy. Another risk is that the 'abnormal' growth in China will coincidentally subside right after the Olympics. The reverberations of such an occurrence will be felt everywhere. Still, imagine if every Chinese citizen purchased just one Coke per year? If 'they' actually paid for their Windows software?

American companies, are benefiting, from the current low dollar; as USA made goods and services are becoming much more competitively priced, exports will continue to rise as will *repatriated* profits. The resulting increase in corporate earnings is an important inflexion point that will, over time, lead to higher valuations of US equities and in the USD. And in a best case scenario, if the China and India 'experiments' work, if intellectual property rights are respected and enforced, then the USA will have another 1.5 billion consumers to satisfy with their *Made in the USA* products.(***Conceived** in USA* products)

Why invest outside of Canada?
- a small market globally (about 2.3% of World's investable assets)
- not all desirable Industry and Asset classes are represented here and in enough depth.
- a prudent manner to diversify risk of income, geography, currency
- For thirty years to 2003, the Canadian dollar had fallen in value by 40%. Current strength of CAD masks vulnerability: of our economy, our standard of living, employment base(s), eroding tax-base, international measure of wealth.

Which is the best asset allocation for you? One that will help your savings remain intact and grow, throughout the violent and undesirable events and challenges which over time, constantly and uncommonly surface. Maintaining a modest Equity diversification and allocation (40-55% of financial assets) along with high liquidities in your Fixed-Income components should serve you well.

Sincerely,
Visavis Investment Counsel Inc.