Barrantagh

Investment Management

CAPITAL MARKETS REVIEW
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Executive Summary

- Synchronized global economic growth (with contributions from the U.S., China, Japan and Europe) will be the key support for economic activity in 2004.

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- Corporate cash flow growth is accelerating in response to positive economic developments and corporate management initiatives.

- Since early 2003, our investment strategy correctly called for equities to outperform bonds. We continue to expect equity markets to outperform fixed income markets in 2004.

- In some sectors, stock prices are ahead of the fundamentals, necessitating a careful selection process based on detailed research and a clear discipline.

- In fixed income portfolios, we have reduced our exposure to government bonds to protect capital. A reversal in Fed policy is likely during the year as today's low rates prove to be unnecessary. Therefore, as we did in 2003, we will emphasize corporate bonds as they reap the rewards of a stronger economy and better corporate performance.

- Canadian interest rates have room to move lower due to the strength of the Canadian dollar and possible slower economic growth vis-à-vis the U.S.

- Recently, economically sensitive income trust vehicles have out-performed in this asset class. However, trust valuations will be a key issue in this equity class for 2004 as concerns mount that interest rates will rise to cool a strong economy.

Synchronized Global Growth

What a difference a year makes! At the end of 2002, pessimism about the global economic outlook was widespread, investors were distrustful, stock markets had been in severe decline, Iraq invasion worries were rampant, corporate earnings were elusive and executives were negative about expansion.

Today, the veil of gloom has lifted. A positive outlook prevails for global economics, corporate profit performance, governance and the stock markets.

In 2003, GDP growth accelerated in the U.S. as the year progressed. Business investment was the main reason for the upside surprise. A key driver in the fourth quarter and into 2004 will be inventory rebuilding as evidenced by strong industrial production. Accelerating growth in business spending will lead to a much more balanced U.S. expansion in 2004 by reducing the recovery's dependence on consumer spending.

Beyond the United States, synchronized global growth will be a key support to economic activity in 2004. A rapidly expanding Chinese economy is providing powerful stimulus throughout Asia and for countries exporting basic materials and other inputs into the Chinese economy. The Japanese economy, which has been chronically depressed over the past decade, is currently experiencing an upswing and the odds for a more sustained recovery are better this time.

Even in Europe both business and consumer confidence are on the rebound. The Euroland economies are ignoring the straitjacket effects of the Stability and Growth Pact, permitting stimulative budget deficits to rise. The main threat to Euroland is the strength of the euro itself, which is up over 35% against the U.S. dollar in two years.

Turning to Canada, the prospect for synchronized global growth in 2004 is good news for Canada's export driven economy. Growth for 2003 reflected a plethora of problems Canada had to face including SARS, mad cow disease, a blackout in Ontario, forest fires in B.C. and a much higher Canadian dollar. Growth for 2004 may lag behind the U.S. due to the sharpest rise of the Canadian dollar against the U.S. on record. Some industries are also beginning to experience intense competition from low-cost nations such as China. Nevertheless, household spending and business outlays should support solid economic growth.

Equity Markets Driven By Cash Flow

As we pointed out last quarter, corporations are highly leveraged to dramatic profit improvement because of a combination of cost-cutting initiatives and improved demand for goods and services. The full benefits of cost-containment, restructuring and productivity enhancement initiatives taken earlier have not yet been fully reflected in earnings. Companies are increasingly generating free cash flow which will be reinvested in their business or used to pay dividends.

The dramatic stock market gains this year were associated not only with economic growth and rising corporate profits but also with the collective opinion of investors that the risk in owning equities had significantly declined. Accordingly, securities normally perceived to be risky generated the highest returns.

We are cognizant that several risk factors have the potential to ultimately derail the bull market and stocks. Paramount among these risks is the prospect that the monetary authorities will shift policy in favor of a tightening bias. Other potential destabilizing events such as a sharp slowdown in the Chinese economy are possible. We have addressed these risks in our asset allocation decisions.

On balance we are confident that solid returns are still available in equity markets and that the risk return tradeoffs favor equities over bonds by a considerable margin. Reflecting our disciplined valuation approach we have added to our holdings of attractively-valued companies poised to benefit from their cash flow generating capability.

One such company is CP Ships, whose price to cash flow ratio is well under 7X, representing excellent value. While most shipping companies manage the business as a commodity, CP Ships manages for profit and return, and therefore is one of the most profitable in the industry. The company stands to benefit from the global economic rebound as shipping traffic increases, and is managed with a sharp eye on the financial statements.

For clients with the appropriate investment objectives, we also continue to invest in well-managed natural gas producers that can grow their production and cash flow from a large inventory of exploration lands. Progress Energy is a holding that exemplifies the type of company that meets our requirements. Over the last year it has doubled its gas production and its cash flow per share, with pleasing results for our clients.

Fixed Income Focus On Corporate Bonds

Evidence continues to mount that the long bull market in bonds is nearing an end. Just how accommodative U.S. federal monetary policy has been is evident from the fact that the real fed funds rate is modestly negative using virtually any measure of inflation. However, with the economy growing strongly, the situation does not seem to warrant what seems to be “a recessionary” monetary stance.

The net effect is that investors are paying close attention to all statements made by the Federal Reserve. The fact that the Fed continues to telegraph its intention to keep rates low increases the odds of a sharp adjustment at a later date and ultimately poses a huge risk for bonds. The longer the Fed maintains its current stance, the greater the ultimate damage to the bond market. Consequently, intermediate and long-term interest rates have a high probability of rising in 2004. This trend will be exacerbated by the large and rising budget deficits, the fall in the U.S. dollar, and a probable slowdown in foreign direct investment.

To address this concern, corporate fixed income vehicles will be the key. We believe spreads between corporate and government bonds will continue to narrow. Therefore, opportunities for yield and capital appreciation in corporate credit markets where credit upgrades are occurring more broadly will be our focus for 2004. If this sounds familiar, it is the same strategy we used in 2003 when similar concerns prevailed, yet fixed income markets performed well, and we outperformed bond indices by a wide margin.

We have shifted the mix much more toward corporate vehicles and away from long term government bonds and we have also extended duration in the corporate portfolio. Rest assured that we continue to favour investment grade bonds and will not entertain junk rated securities.

We have added convertible bonds to the fixed income portfolios to capture yield and capital appreciation. For example, we hold Cameco Corp. convertible debentures, which have appreciated significantly as Cameco's outlook has improved.

As we mentioned in our third quarter report, we added real return bonds to fixed income portfolios as a hedge against inflation. Over the last year, real return bonds have outperformed long-term conventional or nominal rate bonds by a wide margin.

Finally, in Canada the interest rate environment is very different than the U.S., which should be positive for Canadian bonds. The Bank of Canada discount rate is 2.75% and growth is far more constrained than in the U.S. Canadian inflation is on track to move well below 2% and the central bank expects it to stay there into 2005. With the Fed likely on hold well into 2004 it is possible that the Bank of Canada might cut rates to relieve pressure on the currency and maintain an easing bias throughout 2004 thereby supporting the fixed income market in Canada.

Income Trust Update

The performance of income trusts is very sensitive to changes in Canadian bond yields. Recognizing that the interest rate trend could reverse in the not too distant future we have reduced portfolio exposure to income trusts we consider to be particularly interest rate sensitive. The greatest near term concern to us is the apparent high valuation of many such vehicles. The value issue has become more acute as income trust prices continue to rise and total return potential decreases. In keeping with our overall value orientation, we sell those investments that have reached their true value in order to control this aspect of risk.

Barrantagh Investment Management Inc. provides disciplined portfolio management to institutional and individual investors. The firm is committed to a high level of client service provided directly by its experienced partners.

We are dedicated to preserving our clients' capital while generating growth through consistent application of our value-based fundamental investment philosophy.

We manage portfolios on a segregated basis to meet our clients' investment objectives. Because the firm is owned by our professional staff we maintain a completely independent and objective perspective.

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