2009 Q3 Market Commentary

"Less Bad"

When we recently sat down to discuss this Market Commentary we spent considerable time discussing the current economic and capital markets environment. Although there was no consensus on either the state of the economic landscape or capital markets we did agree that although things are better than they have been over the last 12 months there are some considerable challenges that lie ahead. Notwithstanding the surge in the capital markets over the last six months (see comments below) we are concerned with the possible undertow of unemployment (further affecting consumer spending) and other economic indicators - which led us to describing the current state of affairs as being "less bad".

This past year has for many investors been a stressful period testing the level of one's risk tolerance. Understanding the current economic environment and the fact that it moves in cycles will assist investors in maintaining disciplined longer term investment decisions while reducing any emotional worry that sometimes accompanies these periods. The current stage in the economic cycle should allow investors to both take advantage of opportunities and sleep well.

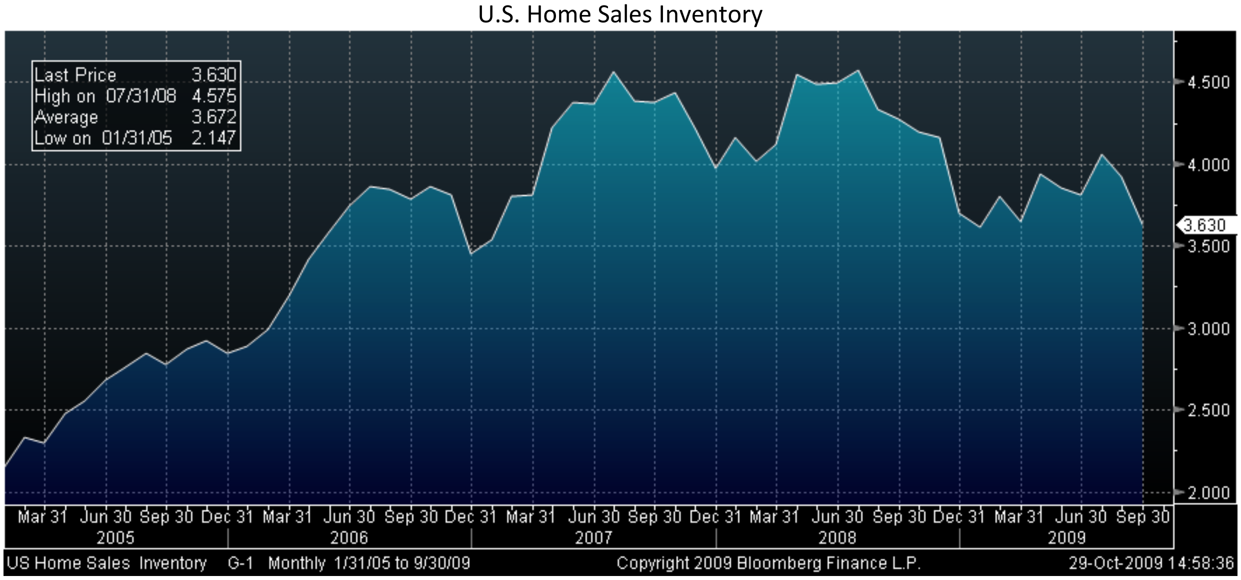
WHERE ARE WE

In the last six months we have experienced a significant rebound in the capital markets as stocks that were very "cheap" have since become "fairly priced". The debt markets are split between government debt which has remained (artificially) low while still wide spreads have made the corporate market appealing. The dilemma in the fixed income market is how to generate some yield without taking on too much risk.

The current debate in the financial press is whether investors can expect a "V" or a "W" recovery in the equity markets. That is whether markets will continue to rise to previous levels ("V") or whether investors can expect a dip before markets rise ("W"). Looking at charts of equity returns over the last six months results in the appearance of a "V" pattern however we are cautious for several reasons.

Firstly, the fundamentals that wreaked havoc on the economy have not been resolved. There is still a housing problem in the U.S. with both oversupply and another wave of foreclosures coming. Banks and trust companies in the U.S. are still not out of the woods. Unemployment is high and, let's face it, consumer spending is the engine that drives the U.S. and has a significant impact on the global economy.

U.S. Home Sales Inventory



Secondly, as mentioned, interest rates are low and do not look to rise in the short term. Inflation is not a problem right now but clearly the stage is set for higher inflation down the road as governments wrack up huge deficits and will have the extremely challenging task of either cutting the budget, raising taxes or both.

Thirdly, much of the recent economic growth has been a product of government stimulus spending the balance of which will be deployed in the short term but will not and cannot continue long term.

Fourth, even if a “V” scenario unfolds, as investment managers Quadrant needs to manage downside risk and therefore contemplate investing for a “W” recovery. Steps taken include dynamic hedging of U.S. currency, re-balancing of portfolios, introduction of additional asset classes and securities selection by investment managers.

INVESTMENT STRATEGIES

In light of the above, it is appropriate now and from time to time for investors to review their asset mix and risk tolerance. This is a key item on our meeting agenda to discuss with clients.

However, rather than retreat and reduce equity content, we feel that the current environment creates opportunities for investment managers and consequently you the investor. We believe that in the next few years active managers (as opposed to passive index investing) have a higher likelihood of outperformance by simply avoiding poorer quality securities that a passive portfolio is required to own.

In this regard, Quadrant recommends asset classes in the large cap equity arena that permit investment managers to invest based upon their best ideas without being tied to a benchmark; managers should not be concerned whether they are underweight or overweight a sector.

Quadrant also recommends some exposure to small cap and developed (emerging) countries. Small cap companies are much better adapted to change in the economy; developed countries such as Poland, Czech Republic and Korea are stable and have not suffered from high levels of consumer and government debt that is strangling the U.S.,U.K. and other large economies.

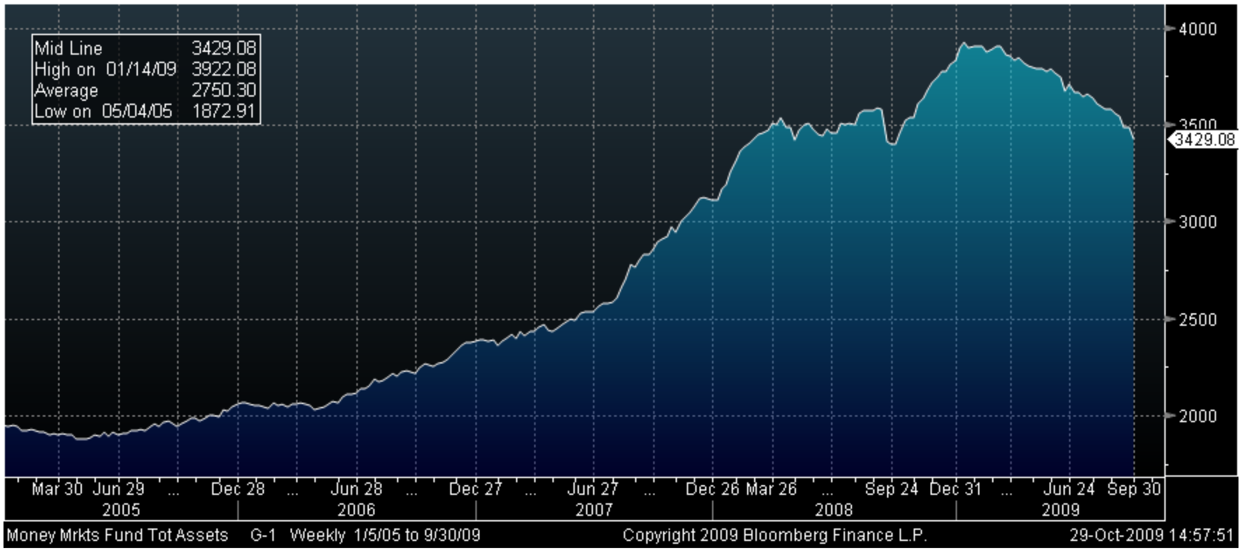
Investing in fixed income presents a dilemma. Fixed income has typically provided yield to a portfolio and some level of support in falling markets. Yield on government debt is at historic lows and possible future inflation prevents many managers from extending duration to obtain a higher yield. This provides opportunity to diversify fixed income into corporate bonds and preferred shares that offer higher yields at acceptable risk levels. Quadrant is recommending adding some alternative “enhanced fixed income” pools to client portfolios.

Quadrant is reviewing all client asset mixes to implement, subject to risk tolerance and income and liquidity needs, changes to portfolios.

ROAD TO RECOVERY

Governments are still providing stimulus; in some countries less than 50% of announced packages have been deployed. This bodes well for some ongoing stability and growth in the equity market only to be countered by investor nervousness – it appears that any news can trigger an exaggerated buy or sell reaction. Until the economic news becomes consistently good, rather than less bad, we do not expect the investor to get fully back into the capital markets. Approximately $3.5 trillion dollars (see graph below) is sitting in U.S. short term funds waiting and significant dollar amounts are sitting on the sidelines in other countries also waiting for market “stability” before investing.

Total U.S. Money Market Fund Assets



The debt load engulfing the world's largest economies suggest that the recovery this time will be slower than previous recoveries. It will take time for government, consumer and corporate balance sheets to repair themselves.

As a result, investor patience is required. Many investors use the high water mark of their portfolios as the basis for assessing the extent of their loss – or what they have to recover. While portfolios have recovered significantly from March, 2009 (see indices below), in percentage terms, a portfolio must recover by more than the amount it declined to be back at the high water level. In the current environment, this may take a number of years. Let us illustrate this by referring to some key indices:

	U.S. Equity S&P 500	Canadian Equity S&P/TSX	World Government Bond
September 1, 2008 to February 28, 2009	-41.80%	-39.80%	-0.19%
March 1, 2009 to September 30, 2009	45.70%	42.97%	12.65%

{Total Returns, U.S. Equity in $US, Canadian equity in $ Cdn. & World Bond Index in $US}

Investors should understand the "math of negative returns". If a negative return occurs, a positive return greater than the negative return is required for the investor to be the same financial position as prior to the negative return. This can best be illustrated by a simple example. Assume that the initial capital is $100 and the rate of return in the following period is -20%. A return of +25% would be required to achieve the initial $100.

1.	Capital – beginning of period 1	$100.00	assumption
2.	Rate of return	-20.00%	assumption
3.	Investment gain/(loss)	-$20.00	1. x 2.
4.	Capital – end of period 1	$80.00	1. + 3.

5.	Capital – beginning of period 2	$80.00	4.
6.	Rate of return	+25.00%	assumption
7.	Investment gain/(loss)	$20.00	5. x 6.
8.	Capital – end of period 2	$100.00	5. + 7.

CONCLUSION

Although the economic and financial environment has improved from where we have been over the last year we stop short of saying we are now in better shape and instead feel that at this point in time “things are less bad” more aptly describes our view. But regardless of this “glass half full – half empty” state of mind, we know that the economy and capital market move in cycles. The stock market is a leading indicator of recovery – meaning that the stock market will rebound many months before things are good in the economy as opposed to less bad. There are no street signs telling us a recovery has indeed arrived. Stay out of the market and you will be on the sidelines watching, instead of participating in the rebound and hoping that things will be less good so you can invest at a market low.

Sincerely,

Quadrant Asset Management

AP/MP/MS/RD