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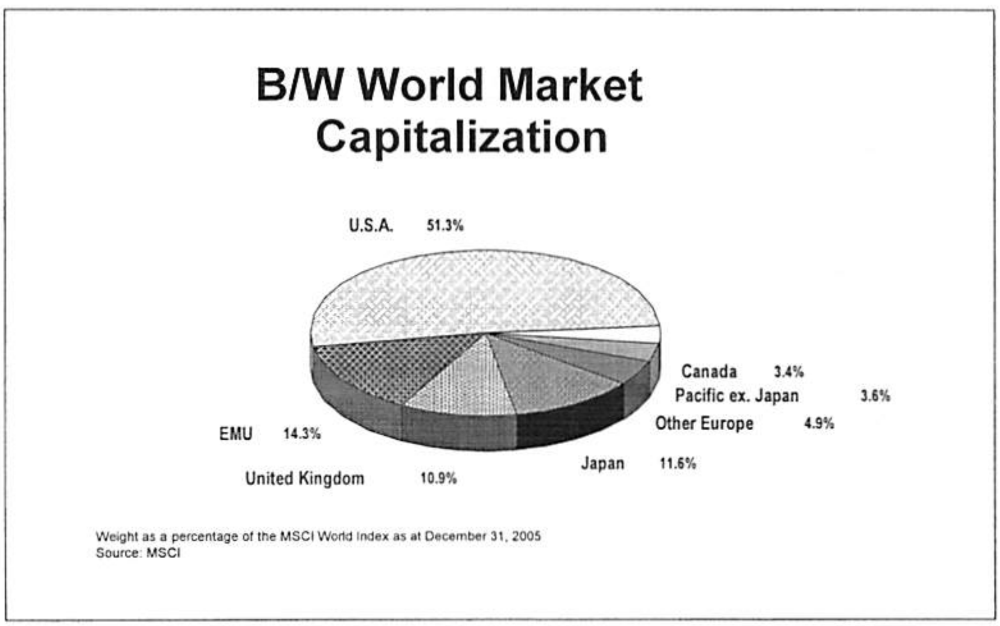
THE 7TH INNING STRETCH STRATEGY

Canadian investors have enjoyed three very impressive years of performance on the Canadian equity markets. Although our closest trading partners (USA) have benefited from good economic performance, it hasn't been reflected in stock prices to the same degree. Price/earnings multiples have been compressing in the US, while expanding in Canada. At first glance, the US markets seem to be more attractive, but this could also indicate a lack of buying interest given the overall state of its economy and its long-term outlook. The negative US currency trend could also be a consequence of this lack of long-term confidence. In addition, the stubbornly low long-term bond yields could also be the reflection of a non-confidence vote from investors who might think that 4.75% for 20 years is attractive!?! Perhaps investors are concerned that the 15-year economic drought in Japan (1990-2005), which drove interest rates to zero, could happen here. After all, it's been nearly 15 years since Japan established a zero interest rate policy!

In Newsletter 32, we talked about the shrinking US market share on the MSCI (Morgan Stanley Capital International) World Index, which reached an all time high in the late 90's at 58% before dropping to 55% in July 2004 and to 51% today (see Chart #1).

Chart #1

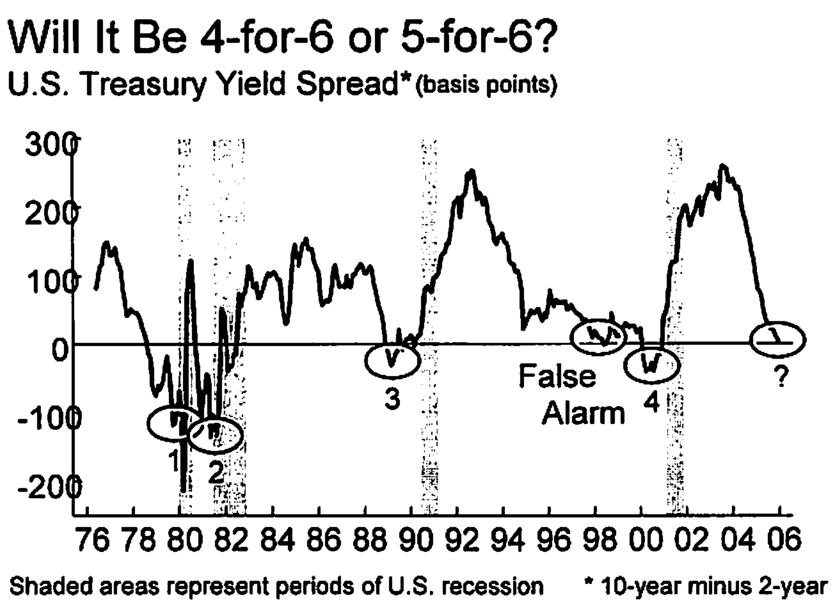


Source: Case of Global Investing, Feb.8, 2006, BMO Nesbitt Burns Research

Meanwhile, Canada's share has expanded from under 2% to 3.4% as the world's demand for energy and raw materials has grown to unprecedented levels. Given this sharp rise in demand has occurred on the heels of a 20-year excess capacity, corporate closures and industry consolidation, new supply is not about to reappear. As these sectors rediscover profitability, they will now focus on creating shareholder value and enjoy the financial capability of increasing exploration expenses to hopefully replace current annual production. In 2006 and beyond, a new ore deposit may be very difficult and costly to bring to production, given today's environmental barriers, aboriginal rights, etc. Furthermore, miners may become nearly extinct by the end of this decade. The supply is getting squeezed, inventories are reaching new lows, and that translates into higher prices and eventually inflation. Global demand is the key, and it is currently showing no sign of slowing down.

In the US, however, the economy is showing more signs of fatigue. In March, as a result of the 15th consecutive interest rate increase, US 10-year and 30-year bond yields had fallen below the 2-year yield, creating an inverted yield curve. Over the past 30 years, this situation occurred five times, four of which resulted in a recession shortly thereafter (see chart #2).

Chart #2



Source: Viewpoint, Quarter 2, 2006 BMO Nesbitt Burns Research

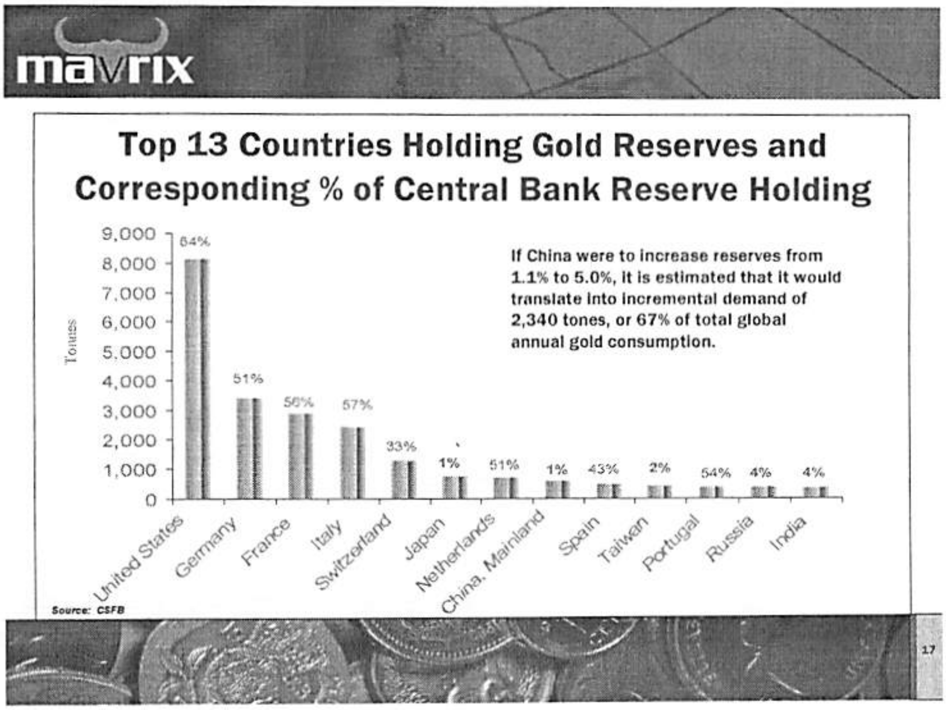
Our BMO Nesbitt Burns economic group, led by Dr. Sherry Cooper and Michael Gregory, do not believe a recession is going to occur this time around. They support their belief noting that short-term rates are not particularly high, nor are they significantly above long-term rates as they were when previous recessions occurred. Although we may avoid a recession, the impact of the negative yield curve is now showing up in a housing market which weakened both in terms of sales and price in February. Perhaps this is just what the Federal Reserve Board (Fed) was hoping for to end the tightening policy (raising rates).

Canada, on the other hand, is struggling with its strengthening currency as this dampens economic growth and domestic corporate profits. As the loonie strengthens, so does our cost structure, making Canadians less competitive. If raw material prices were to weaken simultaneously, commodity producers' profits would tumble. So the key for the Bank of Canada is to help increase corporate Canada's productivity (cutting corporate taxes would help) and monitor the Canadian dollar. Raising interest rates here in Canada may cause our dollar to increase and would also increase the risk of a full-fledged recession as the yield curve could invert even more steeply. Cutting interest rates, on the other hand, may overly stimulate the economy and ultimately drive the dollar even higher. We can therefore conclude that the recent rise in interest rates has yet to fully impact our economy, given the softening that the Canadian economy is experiencing, and that we may witness some stability with regards to the Bank of Canada's monetary policy, relative to the US, in the short-term.

In our last few Newsletters, we questioned the US economic policies, as we reflected on the "twin" deficits (trade and budget), consumer spending habits and unwillingness of consumers to save, causing unprecedented levels of indebtedness, at both the personal and government level. It seems what Alan Greenspan once called "irrational exuberance" speaking of US consumer habits has now become a chronic phenomenon. The new Federal Reserve chairman, Mr. Ben Bernanke, seems to want to tackle these bad habits by raising interest rates, which should slow spending and encourage savings. The risk is that interest rates could overshoot, causing a recession and a drop in the US dollar. The case for gold is partly a result of this danger. It would act as a buffer in a portfolio if such a scenario were to occur. But there are other reasons that support the higher gold price theory. China's foreign currency reserve is about to surpass Japan's $850 billion US, to become the world's largest reserve. The rational behind this strategy (i.e. buying such huge quantities of US treasuries) was to keep interest rates at low enough levels to provide the North American consumer with easy financing to buy Japanese- and Chinese-made goods. That makes the US debt financing dependant on those countries' willingness to buy US treasuries. It also makes China and Japan dependant on the American consumer's willingness to buy foreign goods. But if the American consumer slows his consumption rate and the US economy falls into recession, the US dollar could drop significantly.

Both of these countries are over-exposed to the greenback and should therefore hedge their positions. Gold is the most obvious option. Both of these countries also have among the lowest percentage of these reserves backed by gold, coming in at 1% (see Chart #3). If China were to increase its gold reserves to 5%, they would need to add 2,340 tons of gold, or 67% of the total annual worldwide consumption. That should put some upward pressure on gold prices!

Chart #3



Another recent development was the announcement by the Fed that it would no longer be providing M3 figures (Money Supply) after March 2006. One must question why the Fed no longer wants to report the total quantity of dollars in circulation. Perhaps they worry about investors' reactions given the high probability of massive amounts of dollar creation to fund the worsening trade and budget deficits. Again, the dilution effect of a sharp increase in money supply could drive gold prices up sharply.

All of these situations make us feel vulnerable. One day the worry is inflation, the next day it is deflation, and/or stagnation. How can anyone maintain an investment policy or strategy in the face of these wild, chaotic and irrational irregularities? How can anyone worry one day about the risk of inflation and the next day worry about deflation? These are two completely opposite phenomenon. It seems to me that domestic economies used to be somewhat self-autonomous and self-sufficient. When the economy was overheating or contracting, it was a case of all the industries reacting in tandem. Therefore, either we were in an inflation environment where the economy was over-expanding, or we were in deflation, where the economy was in a depression. Today, with globalization, it seems that some sectors within a single domestic economy can be facing inflation while the others experience deflation. Historically, a central bank would raise interest rates to slow an overheating economy and conversely cut interest rates to stimulate it. But in today's interdependent economies, what is a central banker supposed to do to fight domestic inflation and deflation at the same time? These new and unprecedented times mean that today's central bankers are navigating in uncharted waters. It also means that we may face the unpredictable. As investors, how can we protect ourselves against inflation, deflation and stagnation at the same time? What if we get sustainable growth?

Fidelity's famous, now retired, money manager Peter Lynch, once said in 1987 that during the past century, the stock market experienced 25% drops from previous peaks every 5 to 10 years (bear markets), while experiencing a 10% decline (i.e. correction) every 18 months on average. Mr. Lynch believed that these declines could not be predicted. He maintained that investors should simply expect them to occur and design their asset mix strategy to reflect the short-term risks involved in owning stocks. Therefore the biggest risk is investors themselves, reacting emotionally and/or trying to time the market.

In his 2004 letter to shareholders, Warren Buffet, an extremely popular and world renowned money manager who also happens to be the second wealthiest man on earth, described the importance of staying the course with equities. He stated the three primary causes of investors' mediocre to disastrous performances as being: 1-high costs, usually because investors trade excessively or spend far too much on investment management; 2- portfolio decisions based on tips and fads rather than on the thoughtful, quantified evaluation of a business; 3- a start and stop approach to the market, marked by untimely entries (after an advance has been long underway) and exits (after periods of stagnation or decline).

Given Mr. Lynch and Mr. Buffet's very valuable advice and the fact that we are in the third consecutive year of good returns, we feel we have to be cautious and try to protect ourselves against the unpredictable (i.e. inflation, deflation and stagnation) by staying invested and participating in future potential growth.

To protect oneself against inflation, one must invest in companies that benefit from price increases, namely commodity producers including those in the Oil and Gas, Base Metals, Gold and others industries. No one enjoys paying $1.20/$1.30 a liter for gas, but if you own Petro Canada stock, your profit should offset the price hike. Depending on your investment profile, we believe it would be appropriate to maintain an exposure to these sectors (energy & materials) in the range of 15% to 25% in comparison to the TSX's weighting of 42%. Failing to participate in these sectors would be refusing to hedge against inflation, which could be very risky and erode your purchasing power.

To protect an investor against deflation, a good idea would be to invest in long term bonds. Recent experiences (i.e. Japan) have shown that in a deflationary environment and/or depression, the main engine of the economy, namely the consumer, stalls. This type of economic state could be caused by a major loss of jobs and net worth, generally preceded by a lengthy period of greed, debt accumulation and high standards of living. Central banks would ease monetary policy (lower rates) to try to kick start the economy and encourage the consumer to spend again. Japan's "zero" interest rate policy is about to come to an end in 2006 as it was introduced over a decade ago. When interest rates fall, a fixed rate holding over a long period of time becomes very attractive and market values increase. For example, a $100 Japan bond with a 5% coupon and a 20 year term, was worth over $160 when long-term bond yields fell to 0.8% at the bottom of the cycle (see Newsletter 34, p.7, table 7). Highly-rated utility income trusts (pipelines and electricity) can provide the investor with some protection against deflation while yielding 7% on average today. A 15% exposure in these sectors should provide an investor with a good base protection.

A stagnant economy means very little growth, reduced corporate spending and dormant consumer behavior. The unimpressive and almost sluggish earnings growth that results from this type of environment is directly reflected in equity markets. Most of the portfolio's performance would be generated by revenue generating assets. High dividend stocks and high quality income trusts and bonds would be the best performing investments in a stagnation scenario.

On the other hand, if we have continued growth and a long lasting economic cycle, which is quite plausible, then companies with strong balance sheets and solid management teams combined with a good business plan in growing sectors of the economy are what you cannot afford to miss.

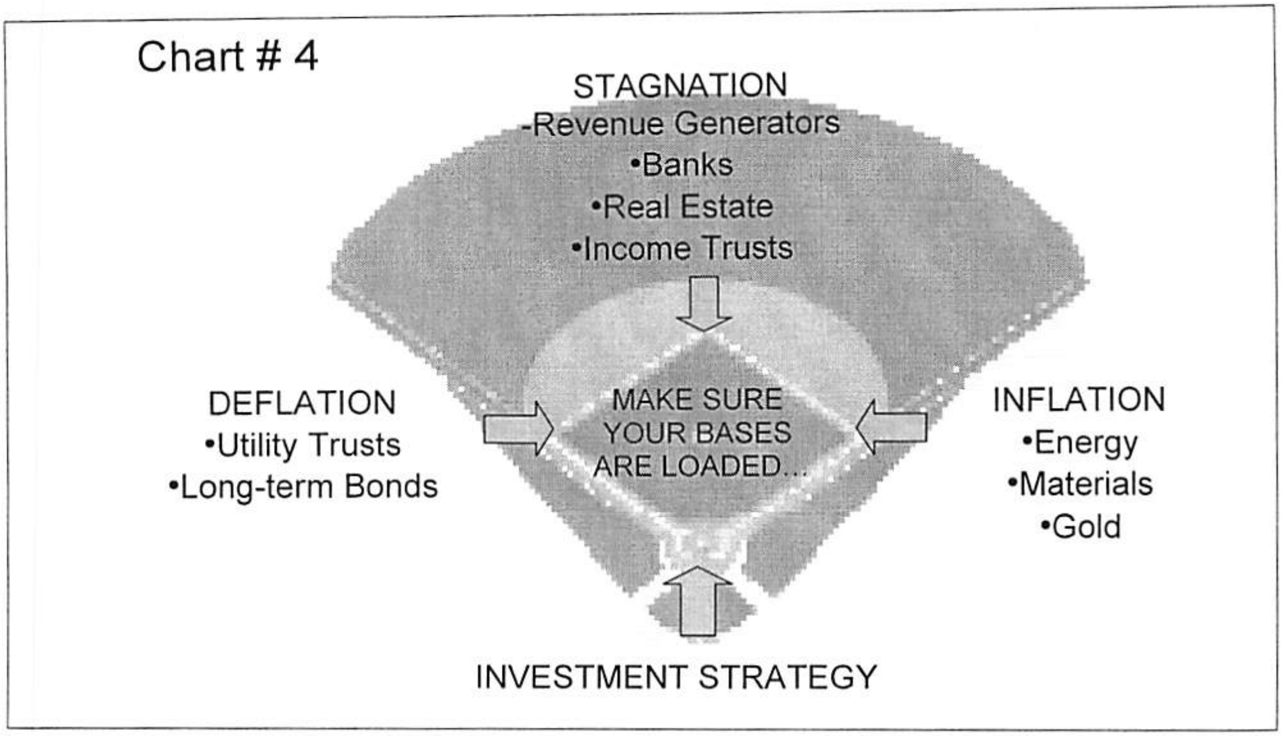
In the future, we will probably refer to this decade as the one during which we saw the biggest transfer of intellectual property (from the West to the East) to a population block at least 6 times our size (400 million vs. 2.5 billion). How can this not create one of the best investment opportunities in history? The so-called "American dream" seems to be catching on and spreading throughout all of Asia. It is contagious but it is not the flu, although money is growing like "chicken pox".

In conclusion, we believe it is best to stay focused on the investment strategy that suits your profile. Make sure your asset mix is in line with your financial plan, your needs and your risk tolerance levels.

The sectors we believe will be among the best performers this year are gold (Newmont, Barrick, and Goldcorp), base metals (Teck/zinc, Inco/nickel, Alcan/aluminum, Quadra Mining/copper, Sherritt/diversified) and energy (Suncor, Cdn Oil Sands, Petro Canada, Encana/gas, Trinidad Energy/services). Banks (Bank of Montreal, Bank of Nova Scotia, Canadian Imperial Bank of Commerce) and insurance companies (Manulife Financial, Sunlife, Power Corp, Industrial Alliance) should face stronger head winds as interest rates move higher, especially in the US, but should remain an intrinsic part of your portfolio.

Companies such as Metro, Alimentation Couche-Tard and Astral Media all offer good growth potential and strong balance sheets in non-cyclical sectors. Commercial real estate companies such as First Capital Realty and Revenue Properties are well funded companies that have a balanced leverage approach and a good dividend policy.

We feel that the advice of Mr. Lynch and Mr. Buffet is appropriate and timely. Rather than trying to hit a homerun on the first pitch, make sure all your bases are loaded…stick to your game plan! (see chart # 4)



ASSET MIX OF MODEL PORTFOLIO

INCOME PORTFOLIO Oct 2005	INCOME PORTFOLIO Mar 2006		BALANCED PORFOLIO Oct 2005	BALANCED PORFOLIO Mar 2006
10%	5%	CASH (CSB, QSB, T-BILLS)	10%	5%
45%	45%	FIXED INCOME (BONDS)	25%	25%
25%	25%	CONVERTIBLE DEBS. AND INCOME GENERATING SECURITIES	25%	25%
10%	15%	EQUITIES	30%	35%
10%	10%	FOREIGN	10%	10%

Pierre Morin - Josée Dupont

INCOME-GENERATING INVESTMENTS

		DISTRIBUTION							(1)			(2)
	CURRENT PRICE	MONTH-LY	QUARTER LY	SEMI-ANNUAL	ANNUAL DISTR. $	CURRENT YIELD	YIELD TO MATURITY	ESTIMATED % TAXABLE	CURRENT AFTER-TAX YIELD	RECOMME NDATION	TARGET PRICE	CREDIT RATING CBRS
DEBENTURE												
PEMBINA PIPELINES CONV DEB	$144.00			3.68	$7.36	5.11%		100%	2.56%	Hold	$100.00	
INCOME TRUST (3)												
ALGONQUIN POWER	$10.39	0.08			$0.96	9.24%		50%	6.93%	Hold	$10.50	S-2
CANADIAN OIL SAND	$167.60		0.5		$2.00	1.19%		100%	0.60%	Hold	$165.00	S-4
EPCOR POWER	$33.75		0.63		$2.52	7.47%		60%	5.23%	Buy	$37.00	S-1
FORT CHICAGO ENERGY	$12.00	0.079			$0.95	7.90%		85%	4.54%	Buy	$12.75	S-2
GAZ MÉTROPOLITAIN PTS	$20.14		0.34		$1.36	6.75%		100%	3.38%	Buy	$21.25	S-1
INNERGEX POWER	$13.95	0.077			$0.92	6.62%		25%	5.80%	Buy	$14.00	S-2
LABRADOR IRON ORE	$29.03		0.35		$1.40	4.82%		100%	2.41%	Hold	$26.00	S-3
NORTHLAND POWER	$14.57	0.083			$1.00	6.84%		80%	4.10%	Hold	$14.00	S-2
PEMBINA PIPELINES	$18.05	0.088			$1.06	5.85%		80%	3.51%	Hold	$14.50	
RIOCAN	$23.06	0.106			$1.27	5.52%		55%	4.00%	Hold	$23.50	S-2
TRANSALTA POWER LP	$8.75	0.066			$0.79	9.05%		55%	6.56%	Hold	$9.00	S-1
TRINIDAD ENERGY SERVICES	$17.74	0.085			$1.02	5.75%		100%	2.87%	Buy	$22.00	
WESTSHORE TERMINALS	$11.25		0.325		$1.30	11.56%		100%	5.78%	Hold	$13.90	S-4

1) Assuming a 50% marginal tax rate.
2) Varies between S1 to S7, S1 being the highest
3) Income may be subject to fluctuations.
4) Current net asset value $16.73. Redeemable at n.a.v. in August 2007.