LEITH WHEELER INVESTMENT OUTLOOK

Fourth Quarter 2007

Playing In The Casino Royale

Leith Wheeler is proud to once again be a corporate partner with the Playhouse Theatre Company. Our sponsorship of the production of Timothy Findley's The Wars kicks off the 07/08 season on October 13th.
www..vancouverplayhouse.com

Leith Wheeler is also proud to be a season sponsor with Music in the Morning.
www.musicinthemorning.org

So you thought that bonds were boring. Clip a few coupons, have your capital paid back at maturity, and enjoy the safety net alongside your equity portfolio. Nothing too flashy...more Moneypenny, less Halle Berry. What could be less complicated? Summer 2007 in the bond markets, that's what.

ABCP...would you buy it?

Asset Backed Commercial Paper (ABCP) structures became headline news in Canada just recently. You probably have never heard of it before, and if you owned it, you wish you hadn't. If the acronym is new to you and you're reaching for a financial dictionary, doesn't that tell you something about the risks? ABCP notes return your capital after 30 days but the assets backing the promise extend out **several years**. At the end of 30 days, the investor relies on another buyer to provide his return on investment, and that next person in turn gets paid back after the next 30 days. As long as there is confidence in the underlying assets, and other investors follow down the chain, you live to die another day. Or not.

The issuers of ABCP paper had the ability to purchase many different types of assets to back the investments, without even notifying the investors. Suffice it to say, you could have driven a truck through the list of permissible assets it was so broad.

What created the mess?

The collapse of confidence in the ABCP market was linked to the defaults that had begun escalating in the U.S. sub-prime mortgage market. Greedy loan hustlers, many of whom were unlicensed phone operators working as independent agents, got the borrowers signed up. Wall Street was the intermediary by providing packages of mortgages (collateralized debt obligations, or CDO's) to investors looking for ways to diversify the risks. The rating agencies and investment banks joined in the party to collect their fee. Yield hungry pension funds invested through hedge funds and other vehicles. Too many stakeholders involved in the game of mispricing risk, all too far removed from the loan itself. The borrower couldn't really afford the property and it was purchased at a property market peak. But the property price was bound to keep going up, wasn't it? (It must...how else would the borrower be able to buy another toy using their tax deductible mortgage line of credit?)

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A byproduct of these CDO's were **packages of packages of loans** (CDO's squared) ostensibly to diversify the risk further by pooling even more borrowers together and offering it to those wanting these higher yielding investments. Even more complex were packages of CDO's squared, with literally thousands of borrowers in the pool. The more complicated to unravel, the higher the fee, the easier to sell, the more investors should have been wary. Some of these issues were no more likely to preserve capital than an hour of roulette. Some high profile institutions created hedge funds that invested heavily in these securities, and some of these funds have imploded.

We stayed away from U.S. sub-prime backed debt obligations. The yields looked tempting but the risks did not. The good news for us as investors is that when markets become flustered, many products – both good and bad—are painted with the same brush. And that's what happened in the Canadian asset backed bond market—a market we have been investing in for the last 10 years.

The mortgage backed bonds in our portfolio that we have been adding to are backed by Canadian borrowers with a much stronger credit history. The loan payments match the maturity of our debt payments, so the pool does not require constant refinancing. The debt is reduced on a specified schedule, leaving more security in place for the remaining borrowers (us). As a result, our bonds tend to get upgraded by the rating agencies as they age.

As an example, we are finding mid-term bonds backed by commercial mortgages, rather than residential ones, that pay almost 1% more than government bonds. Our homework suggests that some of these pools can withstand significant defaults and property losses (way beyond what would be reasonable, even in a deep recession) before we would lose any of our investment.

Our team of fixed income research analysts continues to search for these kinds of opportunities. As asset backed bonds weakened, so did corporate bonds, providing us with further bargains that we have been patiently waiting for over the last five years. We are adding to the bonds issued by good quality businesses where the rewards look very high and the risks quite manageable.

So is it a good time to own bonds?

As with all large changes in the market, the correction in the corporate and mortgage bond markets has been overdone. Both strong and weak companies saw their bonds lose a significant amount of value. For value investors like Leith Wheeler, this is an opportunity that we see infrequently. Ignoring the market noise and trusting our research is the hallmark of our firm. We like some of the opportunities we are finding, both among bonds in the healthiest financial sectors such as the banks, as well as sensibly structured asset backed and mortgage backed bonds. Good companies and healthy borrowers will survive the current turbulence and the bonds we have purchased should benefit. Who needs James Bond.

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