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# The Quarterly Letter

## The Quarter in Review...

The second quarter of 2005 has allowed our typical customer to recover completely the portfolio setback experienced in March, and moreover to post an impressive mid-year performance. In the first 6 months of 2004, the return of our typical customer was approximately 1% (8.4% for the whole year), whereas it stood at 4.8% as of June 30th, 2005, an annual rate of some 9.6%.

Various factors explain the strong start in 2005: i) lower long-term interest rates, from which we have been benefiting for several quarters now thanks to our bond strategy (we have extended our aver-

age duration) and our overweight position in Canadian banks; ii) the significant new lease on life of the basic material sector which had suffered a setback at the beginning of the year; iii) the impressive comeback of our consumer-based securities (Alimentation Couche-Tard, Jean Coutu and Saputo); and iv) the enticing performance of our Southeast Asian investment (8% to date in 2005).

Our selection of securities has continued to make the difference, providing added value in a market that, up until now, has been by and large quite bleak in 2005. The stock market in Canada has posted an



increase of 7.1% since the beginning of year and is only marginally profitable in the United States. Interest rates remain very low, from 2.43% for short-term rates to 3.75% for long-term ones.

Have a very pleasant summer!



The Dalpé-Millette Group

### Contents:

|                                |   |
|--------------------------------|---|
| The Bond Market                | 2 |
| The Currency Market            | 2 |
| Canadian Stocks                | 3 |
| US Stocks                      | 4 |
| International Stock Exchanges  | 4 |
| Review of Portfolio Activities | 5 |
| Basic Information              | 6 |

## Selected Statistics

| Month             | Interest Rates    |                 |                  | Stock Exchanges |          |              | Currencies |        |       |
|-------------------|-------------------|-----------------|------------------|-----------------|----------|--------------|------------|--------|-------|
|                   | Canada Short-Term | Canada Mid-Term | Canada Long-Term | CAN TSX/SPX     | USA DJII | Intern. EAFE | USA\$      | EURO   | YEN   |
| <b>Dec. 2004</b>  | 2.47              | 3.68            | 4.30             | 9247            | 10783    | 1515         | 0.8303     | 0.6077 | 85.60 |
| <b>March 2005</b> | 2.56              | 3.87            | 4.32             | 9612            | 10503    | 1504         | 0.8220     | 0.6350 | 88.40 |
| <b>April 2005</b> | 2.45              | 3.53            | 4.14             | 9369            | 10192    | 1463         | 0.7950     | 0.6177 | 83.36 |
| <b>May 2005</b>   | 2.43              | 3.35            | 3.92             | 9607            | 10467    | 1457         | 0.7946     | 0.6342 | 86.16 |
| <b>June 2005</b>  | 2.43              | 3.17            | 3.75             | 9903            | 10275    | 1474         | 0.8142     | 0.6750 | 90.03 |



## The Bond Market

As expected, for the seventh consecutive month, the Bank of Canada has decided to keep the overnight rate unchanged at its last meeting on May 25th. Its target rate for one-day financing therefore remains at 2.5%. The current pause in monetary contraction is required due to the uncertainty related to developments in international trade.

In the United States, investors who banked on the imminent end of interest rate increases will have to wait. The Chairman of the Federal Reserve (Fed), Alan Greenspan, considers that the U.S. economy seems "to be on a reasonably firm footing, and underlying inflation remains contained". The Fed has already raised its leading rate on nine occasions in the last year, bringing it to 3.25% during its last

meeting on June 30th.

However, the enigma raised by Alan Greenspan in February has not been solved. The Chairman of the Federal Reserve had shaken the bond market by asserting that he did not understand why bond rates were not rising despite the fact that the central bank was raising its short-term rates on a regular basis. Mr. Greenspan was still bewildered by the weak level of long-term interest rates. The decrease in rates constitutes the "greatest surprise of the year" according to him. It must be noted that the yield on 10-year Treasuries fell 70 basis points in the last year, to slip under 4%, even if the Fed raised its leading rate by 200 basis points.

At the beginning of the year, a study among 66 economists estimated a 4.7% return for 10-year bonds in July. These forecasts seem far from reality because, on June 3<sup>d</sup>, the 10-year yield hit 3.8%. Indeed, investors who challenged these forecasts and who nevertheless bought long-term bonds reaped a surprising return.

For the quarter, the Scotia McLeod Index for long-term Canadian bonds posted a 7.7% return and the Scotia McLeod Universe index posted a return of 4.5%. In the United States, the J.P Morgan bond index recorded a 3.8% return for the same period.

The Fed has raised its leading rate on nine occasions in the last year.

## The Currency Market

Having gained 21% against the USD in 2003 and 8% in 2004, the loonie has been losing altitude since the beginning of the year.

On April 28th of this year, the Canadian dollar fell under the \$0.80 US mark, the first time since the ascent that sent it to \$0.85 US in the fall of 2004. Since the beginning of the year, the loonie has lost 2% against the greenback and gained 1% in the quarter.

Ever since the last time the Canadian central bank increased its leading rate last October, the American Federal Reserve (Fed) has raised its rate on nine separate occasions, which has rendered the yields on American debt securities more attractive than Canadian investments. At the moment, the

spread between Canadian and American rates is the highest since March 2001. Remember that lower rates favour an outflow of capital, which negatively affects the currency in question simply because large global financial institutions buy bonds and shop all over the world for the best rates.

Oil prices underwent important setbacks on international markets, falling under \$49 US in April, hence contributing to the loonie's troubles. Canada being a net exporter of petroleum, fluctuations in the price of crude oil often have an impact on the Canadian currency.

The decline of the US dollar was such that, at the beginning of 2005, the world financial commu-

nity expected a possible correction of the greenback. However, as the Fed pursued its monetary tightening, we have seen the greenback recover 2% since the beginning of the year against the loonie.

Following the rejection of the EU constitutional treaty by a majority of 55% of French voters, the euro's decline continued from its peak in December. The European currency has now lost 11.8% of its value against the greenback during the last six months, sliding from \$1.36 US to \$1.20 US. The euro has declined by 7.7% against the greenback for the quarter.

The loonie has been losing altitude since the beginning of the year.



## Canadian Stocks



After several weeks or even months of depression, stock markets have recovered since the end of April. Investor enthusiasm seems to have returned in May. A wind of positivism breathed vigour into North American stock indexes. The TSX, in particular, distinguished itself, ending on a positive note with a gain of over 7.1% since the beginning of year 2005. Strangely, the upsurge in stock indexes is due to the same reasons that pushed them down during previous months: recent developments in the price of oil, the rate of growth in the economy and monetary policy expectations.

The 2nd quarter of 2005 had mixed results in terms of sector performance, since only six of the sectors ended in positive territory. No one doubts that the key Toronto index ended higher this quarter following the repeat performance by the energy sector which, in spite of a strong decline in oil prices in April, made a comeback to eventually settle at

12%. For its part, the utilities sector gained 8.9% and the consumer discretionary gained 5.4% to take third place overall in terms of return. Contrary to all expectations, the automobile and its components industry dug out of the hole where it had fallen in April therefore influencing the return of that sector.

The losers for this quarter come as no real surprise. The technology sector posted the worst return (-6.4%) followed once again by the health sector, which fell by 4.2% subsequent to the announcement by major players of bad news from clinical studies. Finally, the material sector also posted a negative return of 4.2%. A slowdown in demand has likely begun to be felt, resulting among other things from a cooling of the American economy. Inevitably, the Canadian market feels the repercussions of falling raw material prices.

At the economic level, in spite of

the rather bleak appearances, the Canadian economy is in much better shape in the first quarter. Real GDP growth has reached 2.3% on an annual basis. Consumer spending, business investment and government generosity have all contributed to spur growth. Furthermore, domestic demand remains strong and constitutes the engine of the Canadian economy. Foreign trade is still suffering from the strong appreciation of the loonie in 2004.

The Labour Force Survey indicates that the labour market benefited from the creation of 35,400 jobs in May, a level higher than expected, concentrated primarily in the service sector. Nevertheless, the unemployment rate remained unchanged at 6.8%. So, with stable inflation hovering near the median target, the Bank of Canada has sufficient leeway to manage its monetary policy.

Canadian stock market: faster off the mark than most major stock markets.



During the last months, the vast majority of our customers signed and returned the Portfolio Management Agreement, which indicates among other things the investor's profile and the long term target portfolio distribution. One of the reasons to stick to the discipline of following a portfolio model, in spite of the frequent urge to change, is that it is very difficult to foresee market fluctuations and to take advantage of them regularly.

The following table indicates this eloquently. It compares the recent and long-term performance of all balanced Canadian investment funds (portfolios comprising balanced and by and large static weights of the main asset classes – cash, income and stocks) with that of all Canadian investment funds with tactical asset allocations (funds that try to predict market movement and massively reposition their portfolios periodically). **To sum up, the significant portfolio changes made by tactical asset allocation managers have, in a rather systematic way, harmed more that they have helped.**

| BellChart Plus<br>As at May 31, 2005 | Canadian Balanced Funds |        | Canadian Tactical Asset Allocation Funds |        |
|--------------------------------------|-------------------------|--------|--|--------|
|                                      | 1st quartile            | median | 1st quartile                             | median |
| 3 months                             | 1.0%                    | 0.4%   | 0.6%                                     | 0.2%   |
| 1 year                               | 10.0%                   | 7.8%   | 11.7%                                    | 11.2%  |
| 5 years                              | 6.1%                    | 3.4%   | 5.0%                                     | 2.3%   |
| 10 years                             | 8.6%                    | 7.4%   | 6.5%                                     | 6.4%   |

## US Stocks



Following a drop in all of our southern neighbour's indexes (S&P 500: -2.0%, Dow Jones: -3.0%, Nasdaq: -3.9%) in April, American markets rallied. Diminishing fears about inflation kick started the summer rebound in the market at the end of April. The S&P 500 and the Dow Jones gained 3.0% and 2.7% respectively in May, while Nasdaq climbed 7.6% for the same period. Then, at the beginning of June, Alan Greenspan, Chairman of the Federal Reserve (Fed), indicated that he believed that the American economy rested on a reasonably firm foundation, giving a further boost to the stock market comeback.

However, in spite of the rise in May and June, the current year-

to-date return of market indexes in United States is anaemic. The S&P 500 index ended the first six months of the year 2005 down 1.7%, the Dow Jones fell by 4.7%, and the Nasdaq lost ground with a decline of 5.5%.

The most recent economic data confirm the message delivered by the Chairman of the Fed. Indeed, since mid-June, statistics are encouraging in spite of a slowdown in economic growth rate this quarter. The consumer price index has decreased (a first since July 2004) and industrial production results are better than expected. Furthermore, housing starts continued to progress in May, the fifth increase in six months. We are also witnessing better

morale amongst consumers in June, for the first time this year. The current account deficit has set a new record however, which is partially explained by the appetite of Americans for imported goods.

In conclusion, the weakness of long-term interest rates combined with the Fed's vigilance with respect to inflation have reassured investors and have supported equities for several weeks, in spite of the upsurge in oil prices.

American indexes have bounced back from 3 to 7% from their lows in 2005, set on April 20th.

## International Stock Exchanges



Overseas, Asia is holding steady whereas the economic climate in Europe is deteriorating. The OECD leading indicator has entered negative territory for the first time since April 2003.

European equities climbed in mid-June, pushing the core indexes to heights unequalled in the last three years. Germany and France have put in a good showing this quarter, appreciating by 5.5% and 4% respectively, whereas Italy has lost 0.5%. Since the beginning of 2005, the French index is the overall winner with an increase of 10.7%. The German and Italian indexes end the first six months of the year with a return

of 7.8% and 3.6% respectively.

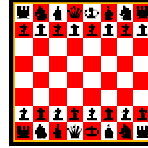
Asian economic prospects remain good. Keeping the pace it set in the first quarter, Japan's economic recovery seems to rest on a more solid foundation with the improvement in the bill of health of Japanese companies. In June, the Japanese government became more optimistic, for the first time in eleven months, due to improvements in both consumer spending and in the labour market. Nevertheless, the Nikkei 225 did not manage to recover the ground lost in April and ends the quarter down by 0.7%. On a year-to-date basis, the Nikkei has gained 0.8%.

In China, the economy still shows no sign of fatigue. According to the latest statistics, industrial production as well as retail sales is progressing faster than anticipated.

Finally, due to the weakness of the manufacturing sector and the slowdown of consumer spending, the Bank of England has maintained the status quo of its leading rate for a tenth consecutive month. The United Kingdom's index ends the quarter with an increase of 4.5%.

Imbalances increase in international markets.

## Review of Portfolio Activities



Having made a relatively high level of transactions during the 1st quarter of the year, we have been less active in this respect over the last three months. At the beginning of June, we decided to liquidate our holdings in Japan, which account for approximately 3% of our typical customer's portfolio, and to distribute it evenly in shares of Alcan and the Fidelity Far East fund. In so doing, the weight of equity securities was not affected, but we did increase our investments in Alcan and Fidelity Far East by almost 100% and 30% respectively.

We consider that, during the next few quarters, the Japanese stock exchange will not perform any better than world stock exchanges overall and therefore we prefer more prom-

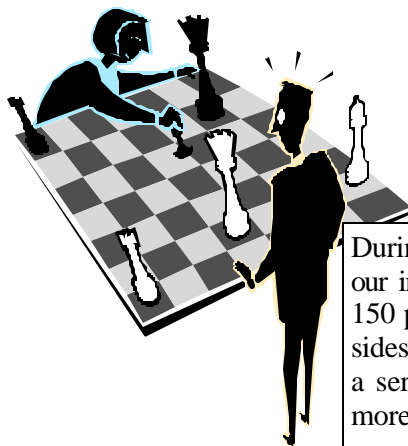
ising investments. The drop in the price of Alcan shares over the past few months, in line with those of other producers in the base metal sector, the valuation of Alcan, which we consider extremely interesting, and its prospects for profitability incite us to add to our position in this quality stock.

Moreover, we are optimistic about the continued growth of major companies operating in Asian countries bordering China. Our investment in Fidelity Far East funds have posted a return of 21% a year over the last two years and we believe that this region of the globe will continue to outperform the average for several more years.

We are pleased that the good performance of our portfolios

to date in 2005, compared to relevant indices and other portfolio managers, was achieved in spite of the fact that we have reduced the weight of our equity position within the portfolios. Indeed, in our Q1-2005 quarterly letter, we indicated our intention to decrease the weight of equity as a precautionary measure. Our portfolios are currently underweight in equity relative to a neutral position.

We have liquidated our holdings in Japan.



During the last quarter, we have proceeded with a substantial redesign of our in-house software, with which we have been preparing approximately 150 personal financial planning reports annually for over twelve years. Besides a new "look", our planning process allows us to produce automatically a series of simulations and sensitivity analyses, and to take into account more scenarios than were previously possible.

Do not hesitate to communicate with us to have access to this service at no extra cost.

**Members of the Dalpé-Milette Group:**

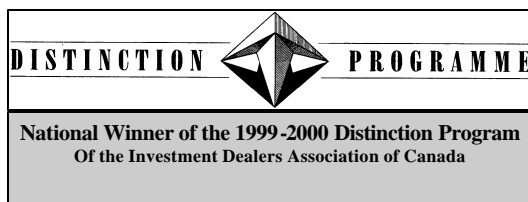
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# Info Sabius



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