Presentation at Club X Family Office Investment Conference

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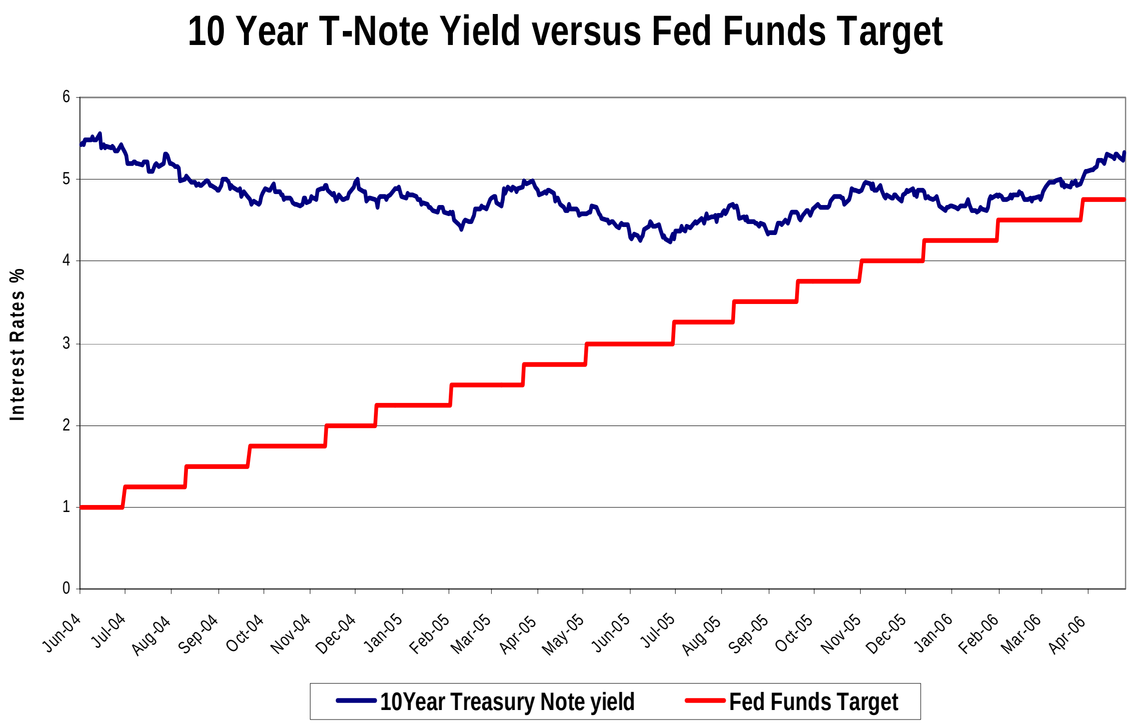
Are there attractive Income opportunities left? YES.

Doug Knight

Our panel has been asked to comment on income strategies. Even though bond yields are close to 50 year lows and corporate credit spreads are tight, we are still finding attractive income opportunities. We have a bottom up investment approach and we have been able to find income opportunities in private debt investments, bridge loans, certain income trusts, and out of favour special situations. Portfolio holdings in these areas have driven most of the returns for our income clients in recent years.

U.S. bond yields remain low despite a quadrupling in U.S. short rates, shown in the chart below. The fact is that 10-year U.S. bond yields are no higher today than 2 years ago even though the Federal Reserve has increased the Fed funds rate steadily from 1% to 4-¾%. We don't speculate on the direction of bond yields but it is obvious bond yields have no room to decline given the floor that high short term rates create. The result is, floating rate and shorter term debt is more attractive than long term debt.



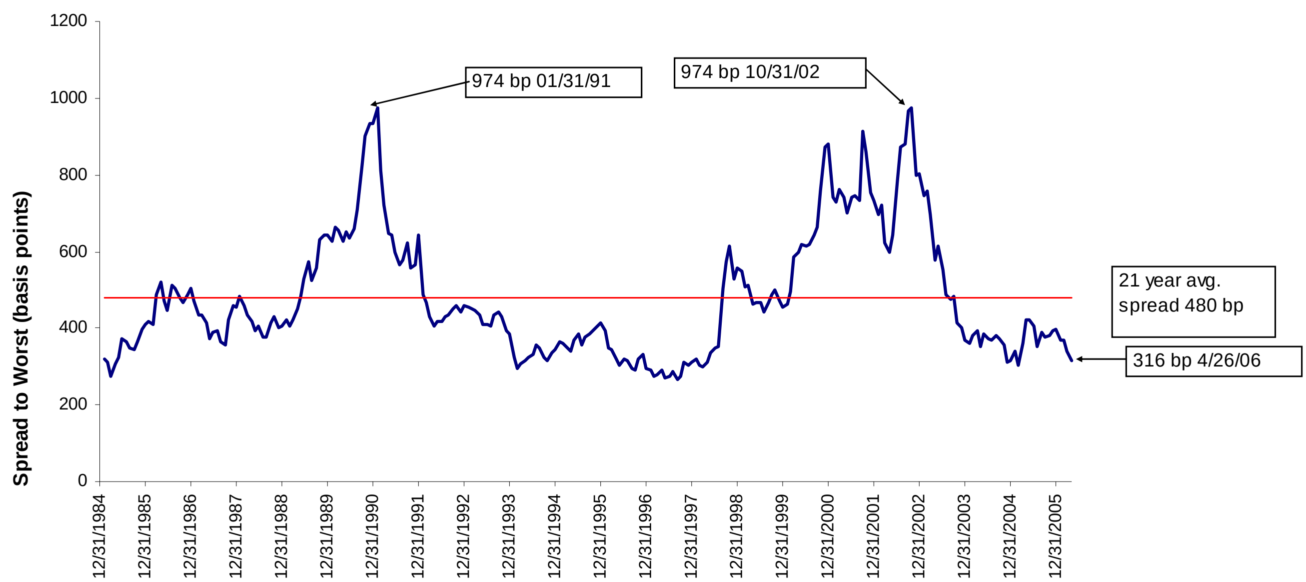
While U.S. interest rates are low, they are still among the highest in the world. Looking at 10-year bond yields in the G8 countries plus Europe (a total of 19 countries) only one country has higher bond yields than the U.S. Normally, a country with a weak currency, like the U.S., is forced to increase interest rates in order to attract support for the exchange rate from foreign lenders. The U.S. dollar is different, as the world's reserve currency, the U.S. does not have to be concerned about the level of the U.S. dollar. The opposite is true; a weak U.S. dollar is forcing other countries to maintain lower interest rates. In Canada, for example, the strong Canadian dollar means the Bank of Canada is pretty well forced to keep interest rate levels below the U.S. in order to stop the Canadian dollar from appreciating even further. Through this mechanism current low rates in the U.S. are being translated throughout the world to even lower interest rates in most other countries, contributing to even greater global liquidity. The owners of this growing global pool of investment assets are pushing up prices for a wide variety of risky assets, in search of returns. Higher prices mean potential returns are declining and risks are rising.

An example of this is credit spreads: in every credit rating category spreads are once again at cycle lows. Shown below are credit spreads for U.S. high yield bonds, which demonstrate the most dramatic cyclical changes. Given the strong economy and low interest rates we do not see credit spreads changing much in the near term; remaining low, similar to the period 1992 through 1998. However, two points of caution:

1. In our opinion credit spreads are not attractive and may be too low, on average, to compensate for real credit risk.
2. Credit spreads will move to higher levels at some point, we just don't know when.

Credit Spread History

Merrill Lynch High Yield Master Index Less 10 year Treasury Yield



Source: Merrill Lynch high yield

Despite this tepid outlook we are finding income opportunities. For example in Private Debt we negotiated an 18-month Promissory Note with Anvil Mining last year. We know the company well because we have owned shares in Anvil for the past year and a half in our equity portfolios. The Note paid a 2% commitment fee, a coupon of 8% and we got an additional incentive of 10 warrants per $100 Note to buy shares at $6.25. In March Anvil raised $150 million through an equity offering using a portion to repay our note. Our return to date, including the “equity kicker” is over 20%.

We also provided a fully secured private loan to GBS Gold International Inc., another company where we know management well. The loan allowed the company to complete a transaction that eventually lead to an equity IPO. We were paid interest of 8% and a large commitment fee on the amount drawn. In February, GBS raised $67 million through an equity offering with a portion of the proceeds used to repay our note. Together with early redemption fees, this Note provided a total return of over 13% in 4 months.

A special situation we purchased is **Jean Coutu Group** 8.5% bonds due August 1, 2014 at an average cost of $92.32 for a 9.9% yield. Jean Coutu’s operations consist of 322 franchised drugstores in Eastern Canada and 1,853 drugstores operating under the Brooks and Eckerd banners in the Eastern United States. The price on Jean Coutu 8.5% subordinated bonds has fallen 10% in the last 7 months as delays in the integration of Eckerd drugstores forced the Company to amend the covenants on its senior secured credit facility. The cost of this amendment will increase the Company’s annual interest payment by only $2.7 million to $204 million, which is a modest price to pay for the increased flexibility to improve the performance of the Eckerd drugstores. Jean Coutu generated $515 million in EBITDA in the last twelve months. After capital expenditures and interest paid, the Company is generating significant free cash flow to reduce the $2.48 billion in debt outstanding. Although we are not expecting strong growth in 2006, we feel investors in Jean Coutu 8.5% subordinated bonds are well compensated by the 9.9% yield.

As an alternative to corporate bonds, we have been increasing our investment in income trusts. For example, our largest holding is **Vicwest Income Fund** which has increased in price by 25% this year. Vicwest has no debt (unusual for a trust) and currently pays a distribution of $1.44 per annum, implying an annual distribution yield of 8.5%. We forecast Vicwest will generate higher distributable cash in 2006 of roughly $2.30 per unit. We expect Vicwest to pay out 80% of cash generated and we believe this will provide a distribution yield of 11% for investors in 2006.

We should insert a note of caution regarding income trusts. Investors are fleeing low interest rate deposits and buying trust units in order to earn higher income. Unlike interest payments, distributions from a trust are not guaranteed. During the past three years, there have been 83 new business trusts issued in Canada. Half of these business trusts are trading below issue price today and 11 have either reduced or suspended distributions all together. Ultimately, trust distributions can be no greater than the cash flow generated by the underlying business. We believe the specific focus on yield by investors encourages some trust management teams to over-promise, particularly at the time of the initial public offering, which leads to problems. Investors must focus on analyzing the underlying business and how much cash flow is being generated rather than just yield.

The point is, in the current environment we are still finding a small number of attractive opportunities. In our view, the worst way to participate in income markets today would be to own a diversified index or basket of over-priced credits or income trusts in an attempt to earn higher yield. The only way to win is to be selective focusing on the best priced income opportunities. With interest rates at 50-year lows and tight credit spreads, low returns offered by many income investments simply do not justify taking the risk in our opinion.

We wonder how any investor could think that a 5% yield on US Treasury bonds due in 30 years represents an attractive long term investment?

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