



DON'T GET GIDDY

It's been a little over a year since the global economy appeared to be teetering on the edge of the financial abyss. Just as some people had started to stock up on canned tuna, bottled water and shotgun shells, the economy regained its balance, thanks largely to a magic elixir known as "cheap money." As is their habit, equity markets anticipated the economic recovery and rallied strongly, with leadership coming from the more economically sensitive industries. A follower of Heisenberg's Uncertainty Principle could argue that cause and effect were actually reversed, that is, it was the equity market rally that provided the requisite confidence for an economic recovery and not the reverse. Regardless, both equity prices and the economy have staged solid recoveries, likely well beyond what the most optimistic economist or market strategist would have dared to predict a year ago. Heisenberg would have loved it.

The current bull market has received a lot of tough love. Investors have enjoyed the lift in asset prices but few have believed in the rally's sustainability. Investors have been understandably wary of believing in an economic recovery when the structural issues that precipitated the crisis largely remain. For the first time in a generation consumers are attempting to live within their means by reducing debt and saving more; however this has largely been offset by increased government borrowing and spending - likely the right policy in a crisis, but unsustainable in the long run. Entitlement guarantees, especially in the United States, have been on the rise when they need to be dialed back - particularly given demographic pressures, as we argued in our last newsletter. Unfortunately it will take another economic crisis for the politicians to develop the resolve to act. These are the clear secular challenges to the economic recovery, not to mention a myriad of other issues such as limited job growth, constrained bank lending, greater government regulations and higher taxes. However, the question remains whether these secondary issues are structural, or rather cyclical constraints that all economies typically face as they exit a recession.

Despite the challenging long-term outlook, we can still have a robust economic recovery over the next year or two. Corporations are in excellent financial shape - even the banks have rebuilt their capital to healthy levels. Many businesses aggressively cut costs during the downturn and are exhibiting an outsized rebound in margins as revenue growth returns. Job growth appears to be just around the corner and tax revenues may actually surprise to the upside. The potential for an economic stumble by China is of concern, but isn't it always? The biggest risk to equity prices now appears to be an eventual rise in interest rates that could hurt stock market valuations and dampen the nascent economic recovery as liquidity recedes. The good news is that inflation remains low and, provided

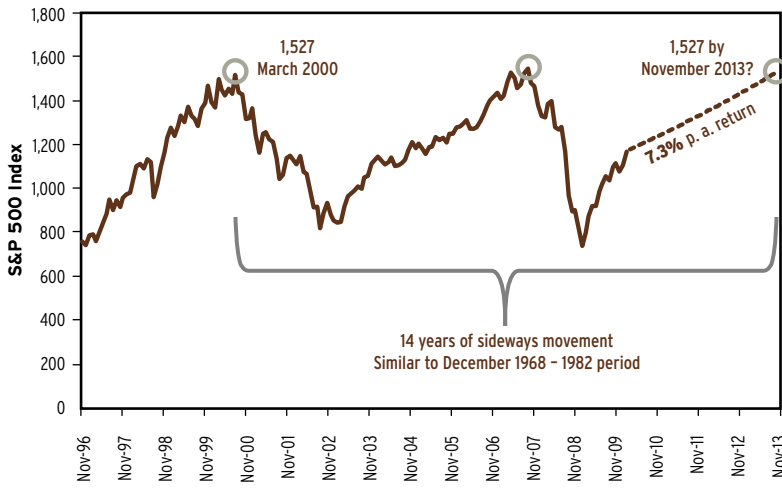
the 10-year Treasury yield stays below 4.5%, we believe that the economic and stock market recoveries will continue. Given the strength of the recovery, it does not seem a stretch to assume that the S&P 500 can get back to pre-Lehman levels of around 1,300 (the S&P 500 closed at 1,168 on March 31, 2010). This would be consistent with credit and stress indicators that receded to pre-Lehman levels in late 2009.

One thing that bulls and bears can agree on is that Canada's economy faces fewer structural challenges than that of the United States. Canada's robust financial system was not impaired and deficit spending truly appears to be transitory. The U.S. recovery relies on a financially strapped consumer, whereas Canada's growth is benefiting from exports to developing markets which are now clearly the drivers of global growth. All of this is reflected in the performance of the equity benchmarks for each country. In the U.S. the S&P 500 *lost* nearly 1% per year, including dividends, over the past decade (ending December 31, 2009); over the same period Canada's benchmark S&P/TSX Composite provided a positive return of 5.6% per year with dividends.

From the time markets plummeted in late 2008 we have frequently been asked if the U.S. equity market is in a multi-year sideways trading range, similar to the 14-year bear market of 1968-1982. Our response has generally caught the questioner off-guard: "it's quite possible, but it wouldn't be so bad." This was particularly true a year ago when the S&P 500 was at 750 and a return to the 1,527 level of nine years earlier would have meant a doubling in equity prices. Our thinking was that even if it took five years to get back to the old highs (to match the 14-year experience of 1968-82), investors would be looking at returns of over 20% per annum. Thanks to the rally in equity prices over the past year, potential returns over the next few years will not make investors giddy, but the outlook is still solid.

We recently updated our analysis to see what equity returns would have to be going forward in order to mimic the 1968-82 bear market (Figure 1). Back in November, 1968, the S&P 500 peaked at 108, a level it would not decisively break through until 1982. This break marked both the end of a multi-year bear market and the birth of a new bull market that would go on for nearly 18 years. Eventually this bull market ended in March of 2000 at 1,527, coincident with the bursting of the technology bubble. Since then, the market has been trapped in a bear market punctuated by cyclical rallies, unable to decisively break out. The S&P 500 briefly pierced the 1,527 level in October, 2007, prior to dropping 58% over the ensuing 18 months (ending March, 2009). At the time of our analysis, the S&P 500



**14-YEAR BEAR MARKET SCENARIO [Figure 1]****S&P 500**

Source: Tetrem Capital Management, Bloomberg
As of March 31, 2010

stood at 1,169. If it climbs to the 1,527 level by November, 2013, the bears should be satisfied, as the condition of a bear market equal to the duration of the 1968-82 bear market will have been met. In this scenario, investors would be rewarded with capital growth of 7.3% per annum. Additionally, assuming that dividends grow in line with capital to yield a constant 1.9%, an investor would enjoy a total return of 9.2% per annum over the next three and a half years – a respectable return by historical standards. The time to be worried about a secular bear market is after years of strong returns, not after years of losses.

This analysis is not meant to be a prediction of returns over the next three and a half years, but rather an illustration of a plausible scenario for equity returns that still satisfies the definition of a long lasting bear market. A 9.2% annual return for the S&P 500 compares favourably to some of the alternatives available to investors. For instance, in the fixed income world, investors can lock in a return of 2.6% over the next five years by purchasing a 5-year U.S. Treasury Note; invest in the Barclays 3-5 Year Corporate Bond Index for an expected 3.1% annual return; or stretch for yield by investing in the Barclays Ba Intermediate High Yield index for 6.7%. Equities may not provide “party like it’s 1999” returns from here, but their prospects are competitive with fixed income alternatives.

From 1926 through 2009, U.S. equities provided total returns of 9.9% per year. It is not realistic to expect much more over the long term. Over the past 84 years approximately 42% of equity total returns

have come from dividends. The importance of dividends to overall returns changes from decade to decade. In the last decade dividends accounted for over 100% of U.S. equity returns, an unfortunate side-effect of the bear market.

As equities gradually return to pre-Lehman crisis levels and rise back toward fair value, the slope of capital appreciation will flatten out and dividends will become a more important part of total return. Accordingly, we have recently increased our emphasis on companies that have strong dividend potential. Our focus is less on current yield - which admittedly we do like - and more on the willingness and ability of management to increase dividends over time. Importantly, we want to invest in companies that have a demonstrable economic moat, where the core business is protected and dividend growth is sustainable.

In the depths of the bear market our investment focus was on “corporate Darwinism.” By that we meant investing in financially strong companies that could survive an economic downturn and thrive in a recovery as they gained market share and pricing power at the expense of weakened or failed competitors. As the economy gradually normalizes, this thesis is playing out. Portfolio holdings such as Best Buy (BBY), Magna International (MG.A), Royal Bank (RY) and JP Morgan (JPM), to name just a few, are thriving. They have all experienced an increase in earnings power that would not have occurred if it were not for the financial and economic crisis in the first place (take that, Heisenberg!). All of these companies are in an excellent position to increase dividend payments in the future.

Stocks are no longer as cheap as they once were and the value opportunity has declined. Consequently, while valuation continues to be our main focus, it is being deemphasized in favour of “quality” and dividends. While we believe that stock prices will continue to climb the proverbial wall of worry, the risk of a market correction is greater today than it has been since the rally began. Bullish investor sentiment is at levels that have historically warranted a cautious near-term outlook. Current low levels of volatility (a signal that investors are complacent) could be poised to rise again. In addition, because secular challenges remain, the market will continue to deal with the aftershocks of the financial crisis in the form of mini-debt crises as we saw in recent months with Dubai and Greece. Therefore we are likely to hold higher cash balances than we have over the past 12 months in order to take advantage of an increase in volatility. Although markets have come a long way from last year and optimism is on the upswing, now is not the time to get giddy.

Daniel A. Bubis, CFA
President and Chief Investment Officer





U.S. MARKET REVIEW

After enjoying healthy returns in 2009, investors were reminded that the path to recovery is not always smooth. Monetary tightening measures in China, a slowdown in U.S. earnings estimate revisions, and debt problems in Greece all helped lead to a mid-quarter correction of approximately 8% - not a surprise after such a big move from the market's lows of last year. As the quarter progressed, investors rightly turned their attention to the impressive fundamental performance of corporate America, casting aside the "macro" concerns for another day. The S&P 500 recovered from the setback and closed up 5.4% during the quarter. The more cyclically-oriented sectors, such as industrials, consumer discretionary and financials, led the advance, while the more defensive sectors continued to lag.

The Tetrem U.S. Equity Composite returned 8.3% (in U.S. dollars), outperforming the S&P 500 by 2.9%. Our holdings in the energy, technology, industrial and financial sectors contributed positively to our relative performance. Among our energy names, Anadarko Petroleum (APC) fared particularly well as the company's exploration program continues to produce positive results. In the technology sector Novell (NOVL) received an unsolicited takeover offer at a 21% premium, and the stock shot above the offer price as investors speculated other bidders might surface. We sold this position at a profit. In the industrials sector our holding in Boeing Corp (BA) rose sharply as the cyclical recovery in the aerospace sector became more evident, leading to an improvement in earnings expectations. Lastly, our holding in life insurer Aflac (AFL) continued to perform well after reporting good earnings driven by a pickup in growth in Japan, a key market for the company. On the negative side, Monsanto (MON)

declined as near-term earnings expectations proved overly optimistic. In the healthcare sector Amgen (AMGN) lagged the market as investors continued to fret about the company's ability to maintain its base business while awaiting new drug approvals. We see good value in both of these stocks and bought more shares on relative weakness.

Through the quarter our portfolio stance remained largely pro-cyclical, which benefitted performance. There is growing evidence that the recovery can evolve from one that was deliberately induced through monetary and fiscal intervention to one that is self-reinforcing, driven by employment growth and capital investment. Aggressive cost cuts have put corporate America in a strong financial position. The operating leverage gained from these cuts should translate into continued earnings growth during the cyclical upturn. We believe the positives at the "micro" level will prevail over the "macro" concerns, leading to opportunities for outperformance through stock selection. As the most undervalued companies soared in value over the past year, valuation gaps have narrowed. This suggests that stock selection will be critical to achieving good returns going forward. We are finding value in companies with stable earnings characteristics and are focusing our research there. Many of these companies generate significant levels of free cash flow and have high dividend yields, with capacity to increase payouts to shareholders over time. As individual stocks within the portfolio approach fair value levels, we will likely be taking profits and investing in these more defensive companies as the year progresses.

Aaron Clark, CFA
Vice President, Investments

CANADIAN MARKET REVIEW

The Canadian market, like others around the world, was affected by a confluence of negative news items in January and February (see U.S. Market Review), and suffered a "mini-correction" of approximately 7%. From there it rebounded strongly in March and finished the quarter up 3.1%. All sectors rose, with the exception of energy which declined 0.6%, due mostly to the sharp decline in natural gas prices. Natural gas is notoriously volatile in the short term, and at the moment there is more supply than demand as a result of a mild winter and still-depressed industrial production - we expect demand to pick up as conditions normalize. Tetrem's Canadian Equity composite rose 3.1%, matching its benchmark. On the positive side, our performance was driven by stocks in the consumer discretionary, financial, and industrial sectors - at a high level, cyclical names continued to rally thanks to increased confidence in the economic recovery. Our slightly overweight exposure to the energy sector acted as a drag on performance.

Aside from energy, our pro-cyclical portfolio focus worked out well in the quarter. For example, autoparts suppliers Magna International (MG.A) and Linamar (LNR) delivered strong double-digit returns thanks to the continued recovery in automobile production. Our investment thesis for each company has been playing out well: their strong balance sheets allowed them to survive the downturn and gain market share from weak competitors, and each is now seeing margins expand as sales start to recover. Despite the big gains in their stock prices, neither stock has reached fair value; each is still coming off deeply undervalued levels at which we built our positions over the past year.

CAE Inc. (CAE) is an aerospace name we recently added to our portfolio. The company is a global leader in the manufacture of flight simulators for pilot training in both the commercial aviation and defense sectors. We purchased CAE at well below its historical mid-cycle valuation when investors feared a prolonged downturn in the aerospace market. This fear seemed overblown, and we are now seeing





TETREM QUARTERLY REVIEW

airlines place new orders with Boeing and Airbus - a big change from last year when the news was dominated by order cancellations. In the long run, strong demand for CAE's commercial flight simulators should be underpinned by several factors: replacement of ageing fleets, new pilot hires due to accelerating retirements and increased global air traffic. As earnings visibility improves, we believe the stock should perform well as investors become willing to value CAE on future results that are likely to be much improved.

Our outlook is essentially unchanged from last quarter: favour the cyclical names, which in the aggregate are still not fully pricing in the potential magnitude of the recovery. Some of these stocks are starting to approach their fair values, and as this occurs we will realize profits and reinvest where our active research-driven process leads us - likely in the more defensive companies that have lagged the market's advance.

Alec MacIsaac, CFA

Senior Investment Analyst

ABOUT TETREM

Tetrem Capital Management offers money management services to institutional and select high net worth clients. Our investment mandates are focused on Canadian and U.S. equities, rooted in our long-standing contrarian value style and tailored to the specific needs of our clients.

Investing is our profession and we are committed to doing it well. Our experienced team's primary focus is seeking out and investing in undervalued companies. For each of our investment mandates, we employ fundamental and quantitative analysis in our rigorous stock-selection process, with a focus on preserving and growing our clients' assets.

For more information about Tetrem Capital Management please visit our website, www.tetrem.com, or call and ask to speak with us about our investment services.

204.975.2865 or toll free 1.866.975.2865

TETREM'S CANADIAN EQUITY MANDATES (Denominated in CDN\$)

	Annualized Returns to March 31, 2010					Calendar Year Returns				
	Q1 2010	1 year	3 year	5 year	10 year	2009	2008	2007	2006	2005
Tetrem CDN Equity Composite										
Gross of Fees	3.1%	41.0%	-1.1%	5.9%	13.5%	31.7%	-28.3%	3.2%	9.3%	31.1%
Net of Fees	2.9%	40.1%	-1.7%	5.2%	12.7%	30.9%	-28.8%	2.5%	8.6%	30.3%
Tetrem CDN Equity Plus Composite										
Gross of Fees	4.3%	46.1%	-0.4%	5.9%	13.0%	33.5%	-31.4%	6.1%	9.8%	29.9%
Net of Fees	4.1%	45.1%	-1.1%	5.2%	12.3%	32.6%	-31.8%	5.4%	9.1%	29.1%
S&P / TSX Total Return Index	3.1%	42.1%	0.0%	7.4%	4.7%	35.1%	-33.0%	9.8%	17.3%	24.1%

TETREM'S U.S. EQUITY MANDATES (Denominated in US\$)

	Annualized Returns to March 31, 2010					Calendar Year Returns				
	Q1 2010	1 year	3 year	5 year	10 year	2009	2008	2007	2006	2005
Tetrem U.S. Equity Composite										
Gross of Fees	8.3%	64.7%	0.8%	6.1%	10.1%	41.8%	-39.2%	8.3%	19.0%	15.2%
Net of Fees	8.1%	63.7%	0.1%	5.4%	9.4%	40.9%	-39.6%	7.6%	18.3%	14.5%
Tetrem U.S. Equity Plus Composite										
Gross of Fees	7.8%	66.9%	1.7%	8.0%	11.4%	43.8%	-39.1%	11.5%	19.2%	22.6%
Net of Fees	7.7%	65.9%	1.1%	7.4%	10.6%	42.9%	-39.5%	10.8%	18.4%	21.9%
S&P 500 Total Return Index	5.4%	49.8%	-4.2%	1.9%	-0.7%	26.5%	-37.0%	5.5%	15.8%	4.9%

TETREM Performance Disclosure

Tetrem Capital Management Ltd., an independent investment management firm, claims compliance with the global investment performance standards (GIPS®). To receive a complete list of composite descriptions please contact us at the above phone number. To receive a presentation that adheres to the GIPS standards, please contact us at the above phone number or see the "performance" section of our website at www.tetrem.com.

Composite Descriptions:**Tetrem CDN Equity Composite-**

Contains fully discretionary Canadian equity accounts following a value investment strategy.

Tetrem CDN Equity Plus Composite

Contains fully discretionary Canadian equity accounts with up to 30% invested in non-Canadian securities (primarily U.S.) following a value investment strategy.

Tetrem U.S. Equity Composite

Contains fully discretionary U.S. equity accounts following a value investment strategy.

Tetrem U.S. Equity Plus Composite

Contains fully discretionary U.S. equity accounts with up to 20% invested in non-U.S. securities (primarily Canadian) following a value investment strategy.

Returns represent past performance. Past performance does not guarantee future results. Different types of investments involve varying degrees of risk. The S&P/TSX Composite Total Return Index comprises approximately 71% of the market capitalization for Canadian-based, Toronto Stock Exchange listed companies and provides broad economic sector coverage of the Canadian markets. The S&P 500 Total Return Index consists of 500 stocks chosen for market size, liquidity, and industry group representation.

Tetrem's mandates are available to institutional investors such as pension plans, group retirement plans and foundations and certain individual investors who meet specified investment criteria. The mandates' performances are not guaranteed, the values change frequently and past performance may not be repeated.

The content of this newsletter is intended for information purposes only and does not constitute an offer to buy or sell products or services of Tetrem nor is it intended as investment and/or financial advice on any subject matter or specific security mentioned. Any commentaries, reports or other content are provided for your information only.

©2010 Tetrem Capital Management Ltd. All rights reserved. This communication is intended for Canadian residents only and does not constitute an offer or solicitation by anyone in any jurisdiction in which such an offer is not allowed. Tetrem's advisory services are available only in those jurisdictions in which Tetrem Capital Management is registered to provide

