



## “ARE WE THERE YET?”

The leaves are turning brown and winter is just around the corner, yet it's difficult to shake the pressing and recurring question of the summer: “Are we there yet?” I can still hear it loud and clear coming from my two young boys Spencer and Jack in the back seat of our car. The frequency of the question was highly correlated to the length of whatever summer drive that we happened to be on. I'd like to be able to say that each and every time the question arose, I showed patience and wisdom, but that wouldn't be entirely honest. However, thanks to the wonders of GPS (Global Positioning System) navigation I could provide an extremely accurate answer as to distance remaining and a fairly accurate estimate of our arrival time, while a friendly voice reminded me to turn right in 500 meters.

Clearly the “Are we there yet?” question also applies to the equity markets, particularly after a rally that has taken the S&P 500 and the S&P/TSX Composite up 59% and 52% respectively from their March lows to their closing levels on October 16, 2009. Unfortunately, there is no GPS measuring device for the stock market to tell us precisely where we are today, but even if there were, we would still have to properly define what, or where, “there” actually is. Here at Tetrem, the two most pressing aspects of the question have to do with where we are in the market cycle and how the cycle relates to stock picking.

Ever since the stock market bottomed in March, many investors and market prognosticators have been questioning the sustainability of the rally. All market rallies are met with doubt and disbelief. In fact, the irony is that the higher the levels of doubt and disbelief, the greater the durability of the rally. This very clear inverse relationship gave rise to the old adage that for markets to rise, they need to climb a wall of worry. In many ways, this equity rally has followed a textbook pattern of the early stages of a bull market, led by stocks from the classic early cycle industries of financials, consumer discretionary and technology. It now appears that equity prices bottomed a few months before the peak in job losses and coincident with a trough in manufacturing orders, two of the best historical indicators of market bottoms. Earnings estimates for individual companies have been steadily rising since the market bottomed, only after sell-side analysts had become sufficiently pessimistic. It took the extreme pessimism of the first quarter of 2009 for expectations to get properly washed out and to set the stage for a rebound. Companies have been broadly beating expectations ever since.

The second quarter's earnings reporting season was quite strong, but was met with bearish commentary as most of the “beats” came from cost cutting as opposed to top line growth. This is typical of the early stages of a bull market. The first round of positive earnings surprises

comes from cost cutting; sales growth comes later. As we enter the early days of the third quarter's earnings season, it looks like companies are again beating expectations. While some of the good results are still coming from cost cutting, we are seeing early signs of revenue growth this quarter. If the historical pattern holds, the fourth quarter's reporting season that starts in January of 2010 will be even more about top line growth than it is about cost cutting. Stock prices require a steady diet of rising earnings expectations to grow in a healthy manner, and the stage looks to be set for a continuation of good news into 2010.

As is typical, the early stage of this bull market was led by junk stocks. As the economic outlook started to appear less grim, the shares of companies that had been under the most duress due to business and balance sheet risks rallied the most. The portfolios managed by Tetrem did not overly benefit from this phenomenon. Back in the January 2009 edition of the Tetrem Quarterly Review we stated that we were avoiding what we viewed as junk companies for the obvious reason that we thought they had a very real risk of going out of business due to the recession. These companies suffered either from a bad business model or excessive balance sheet leverage, and often both. We also knew that if the economic activity were to bottom sooner rather than later, the shares of these junk companies would provide substantial upside returns, likely well in excess of 100%. The problem was that buying the shares of these companies would have been purely speculative, and we were not willing to risk a permanent loss of capital despite the potential upside. We therefore made the conscious decision to avoid junk, a decision that was made easy by the simple fact that there were many higher quality stocks that were also trading very cheaply. Each one of the companies we invested in during the downturn had the ability to survive and prosper. The great lesson of this past economic downturn is the age-old one that leverage can kill. We suspect the grim reaper may yet have unfinished business with some of these junk companies.

So much of the past year in investment land has been less about stock picking and more about getting the “macro” call right. It was about being in or out of the stock market and about being in defensive or high beta (i.e. market sensitive) stocks. The junk rally this year could be dubbed “high beta on steroids.” During the fourth quarter of 2008, when the global financial system went into crisis mode, correlations for all assets converged with the exception of developed market government bonds and, depending on the day, gold. As is typical in the time of crisis, just when investors needed diversification the most, it failed them. The good news is that it now appears we are exiting that phase of the market cycle. Correlations are dropping along with fear gauges such as the VIX (Volatility Index). Not only is this a healthy sign





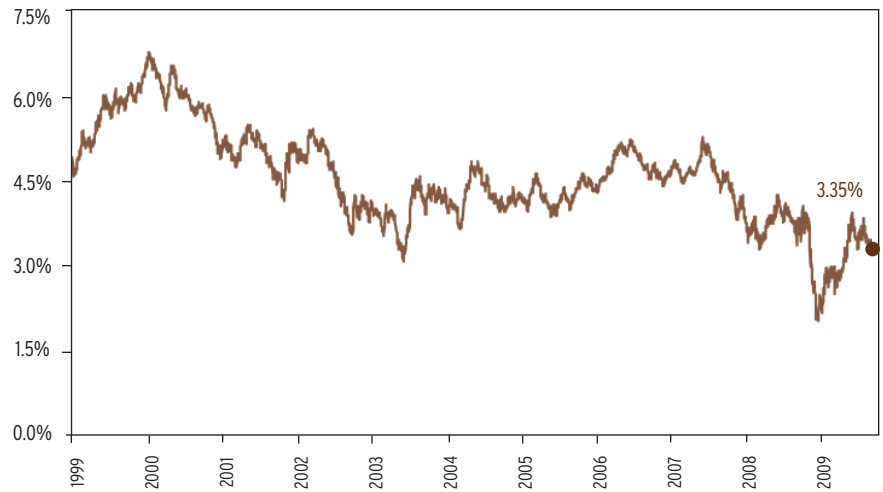
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for the stock market and the global economy, but it is a good sign for active stock pickers: going forward, what you own will matter much more than what you don't own.

In summary, many of the classic signs of the end of a bear market and the early stages of a bull market exist today and a case can be made for continued gains. The one nagging issue is that the trough in economic activity has a feel of artificiality about it. The rebound has been triggered by stimulus spending and monetary easing. Deficits in developed economies, and in particular the United States, are expanding rapidly and eventually those bills will have to be paid. Today it is unclear whether the resolution of the deficit issue will be benign or painful. As we mentioned in the July issue of the Tetrem Quarterly Review, developed economies face strong headwinds from entitlement spending that is on the rise, coincident with the demographic challenges of an aging population.

Our view today: stick with the classic play book until the evidence suggests otherwise. The animal spirits of capitalism have awoken and are on the rise. Merger and acquisition activity is returning along with increasing investment spending by corporations. The cyclical effect of an economic rebound, rising earnings expectations and still reasonable valuations are the fuel for a bull market. And, as stated earlier, investor sentiment remains muted, which is a very positive sign. These positive factors outweigh the large long-term risk of structural deficits, at least for the time being. Ultimately, the real issue for the U.S. is the cost of supporting the high deficit. If interest rates remain low, the U.S. economy has the ability to "skate on side" vis-à-vis its debt levels. The simplest and most logical barometer to measure the cost of deficit funding is the yield on U.S. 10-year Treasury Notes. As long as yields remain low [Figure 1]

10 YEAR U.S. TREASURY YIELD [Figure 1]



Source: Bloomberg - As of September 30, 2009

the consumer will be able to deleverage at a reasonable pace and the economic recovery should continue. Admittedly, this benign outcome is not a foregone conclusion, but neither are the disaster scenarios that some have espoused. For the stock market, if yields were to rise sharply, concerns about the long-term cost of servicing the debt would likely shake the bulls' conviction. Today however, the weight of the evidence supports investing in the stock market in order to benefit from the economic recovery. Hopefully the market rebound will morph into a full-fledged secular bull market, but that is too bold of a call to make just yet. From a contrarian standpoint, that's a good thing.

**Daniel A. Bubis, CFA**

President and Chief Investment Officer

**U.S. MARKET REVIEW**

The third quarter rise in the S&P500 was nearly identical to the performance of the second quarter, making this the strongest two quarter gain since 1975. The move in the market continued to be broad based as all sectors rose during the quarter. Investors continued to embrace risk, leading to outperformance by sectors more leveraged to an economic recovery such as financials, industrials, and basic materials, and underperformance from more defensive sectors such as utilities, telecommunications, and healthcare. As economic data were released over the period, it became increasingly evident that the worst of the economic contraction was behind us and that an economic recovery was likely in the works. Many market watchers are skeptical

about the pace and duration of future economic expansion, but we still have a pro-cyclical tilt in the portfolio as we believe the economic rebound could be longer lasting than many expect.

During the quarter, the Tetrem U.S. Equity Composite returned 17.7% (in U.S. dollars), outperforming the S&P 500 in the quarter by 2.1%. Our holdings in the energy and technology sectors contributed positively to our relative performance. Among our energy names, Anadarko Petroleum (APC) did particularly well after the company's exploration program began producing some positive results. In the technology sector eBay (EBAY) rose strongly as investors started to realize that

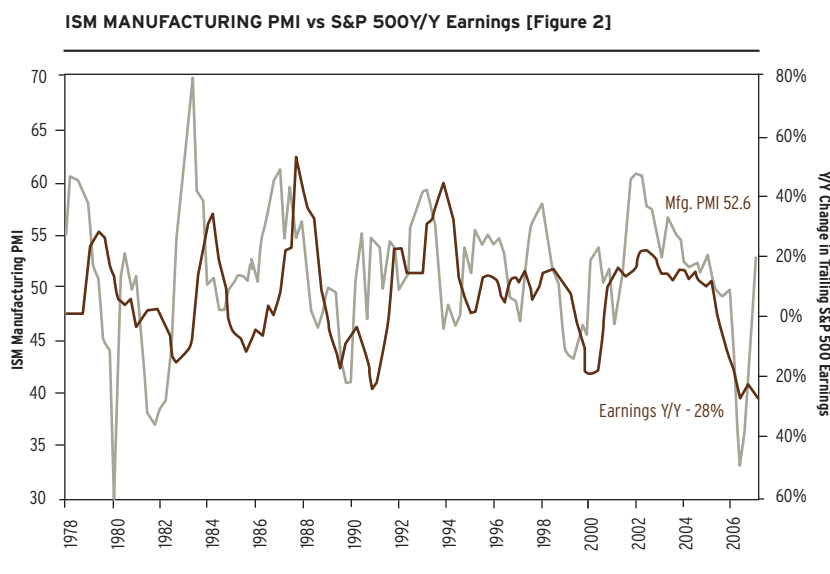




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recent changes to its business should make it more competitive and help it resume growth. Two performance detractors were Medtronic (MDT) and Kraft Foods (KFT) which lagged the market given their more defensive characteristics; however we still see good value in both and have bought them on relative weakness.

Thus far the rebound in the markets has benefited most stocks as we've moved from a perceived Armageddon environment to one characterized by a reasonable level of stability, thanks in large part to the massive fiscal and monetary stimuli from government authorities. There is still plenty of concern about what happens after the foot eases off the accelerator: was the market move of the past six months the beginning of a new bull market, or a bear market rally that is poised to reverse? We are increasingly of the view that this is looking more like a classic economic recovery that could lead to a sustainable bull market. We continue to focus on housing and employment data as key indicators. Thus far, housing appears to have bottomed and is beginning to improve, while employment has yet to really turn. The crucial element for a longer lasting market recovery is an improvement in corporate earnings. Earnings tend to closely track the ISM Manufacturing Purchasing Managers' Index [Figure 2]. It has recovered nicely off the bottom and that leads us to believe that earnings will follow.



Source: Bloomberg, Tetrem Capital Management

**Aaron Clark, CFA**

Vice President Investments

## CANADIAN MARKET REVIEW

The Canadian market continued to defy the skeptics during the quarter, with the S&P/TSX Composite rising 10.6% (including dividends). Year to date the index is up 30%, an astonishing amount when we recall that it had fallen approximately 15% from January to March, when widespread despair reigned. Back then investors faced a tough choice: A) buy at the height of uncertainty (at temptingly-low valuations), or B) wait for clarity (at the risk missing out on the initial "easy" gains). Nearly all investors who chose Door A experienced, for a time, pain and embarrassment as their deal-of-the-decade buys fell shockingly further. Sentiment got so negative that some prophets of doom were predicting the Son of The Great Depression. Fear led to capitulation selling and the subsequent rally provided, in retrospect, a poignant reminder that it pays to be rationally contrarian, especially when there is widespread agreement on the outlook and people are feeling unduly emotional about it. This same lesson was provided under opposite conditions during the Internet bubble, when mollycoddled investors expected stocks to deliver consistent double-digit returns in the 20% plus range. Boy, were they wrong: from its Nortel-inspired peak in September 2000 to its trough in March 2009 the S&P/TSX Composite fell approximately 34%.

Tetrem's Canadian Equity Composite rose 9.0% during the quarter, underperforming the S&P/TSX Composite index by 1.6%. Year to date

results are similar: Tetrem is up 27.3% vs the index at 30.0%. Much of our underperformance was a function of our positioning in the materials sector. We avoided lower quality metals stocks, which have snapped back farther and faster than the broad market - the so-called "high beta" trade. Our biggest position in the materials sector is in large capitalization gold shares, which lagged during the quarter. Finally, the banks outperformed during the quarter, which meant our underweight position in them detracted from relative performance. We like the banks as businesses, but on aggregate they are not cheap enough for us to get overweight. On the positive side, our holdings in the energy sector added to our relative results. Services companies such as Trican Well Services (TCW) rallied hard on the back of rising natural gas prices. In the information technology sector, Celestica (CLS) has been beating expectations and rising off undervalued levels, contributing positively to our relative performance.

We retain a bias toward natural gas-exposed stocks, which we believe are cheap relative to normalized earnings. Natural gas ended the quarter at \$4.86/mmcf, but in the long run should trade in-line with its marginal cost of production, which is estimated to be \$6-7/mmcf. Our holding in Encana (ECA) is one way the portfolio is positioned to take advantage of this positive outlook: it is a low-cost producer, has





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premium assets and strong free cash flow that supports its dividend. Plus, a recent decision to split the company may help unlock some of its inherent value.

On the defensive side, the portfolios maintain a significant position in large-capitalization gold stocks. During the quarter, the management at long-term holding Barrick Gold (ABX) announced its intention to eliminate the company's longstanding hedging program. We see this as bullish for the commodity itself (a smaller outstanding short position - the hedge of 9.5m ounces equates to approximately 12.5% of annual global gold production) and especially so for the stock, which we believe will be re-rated higher as many global investors who had avoided ABX due to the hedge add it to their portfolios. While acknowledging that gold is volatile, we see continued upward pressure on its price over the near term. The metal's recent price strength has the potential to generate significant operating profits for gold producers.

**Alec MacIsaac, CFA**  
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 quantitative and fundamental 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](http://www.tetrem.com), or call and ask to speak with us about our investment services.

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TETREM'S CANADIAN EQUITY MANDATES (Gross of Fees in CDN \$)											
	Annualized Returns to September 30, 2009						Calendar Year Returns				
	Q3 2009	YTD	1 year	3 year	5 year	10 year	2008	2007	2006	2005	2004
Tetrem CDN Equity	9.02%	27.27%	4.72%	0.37%	7.18%	12.38%	-28.27%	3.18%	9.27%	31.13%	15.05%
Tetrem CDN Equity Plus	10.91%	28.59%	3.55%	0.06%	7.36%	12.03%	-31.38%	6.10%	9.80%	29.88%	15.24%
S&P/TSX	10.61%	30.04%	0.51%	1.85%	8.34%	7.27%	-33.00%	9.83%	17.26%	24.13%	14.48%

TETREM'S US EQUITY MANDATES (Gross of Fees in US \$)											
	Annualized Returns to September 30, 2009						Calendar Year Returns				
	Q3 2009	YTD	1 year	3 year	5 year	10 year	2008	2007	2006	2005	2004
Tetrem US Equity	17.67%	35.10%	3.80%	-1.83%	6.16%	10.29%	-39.16%	8.32%	19.04%	15.22%	15.92%
Tetrem US Equity Plus	18.18%	36.48%	5.19%	-0.79%	8.06%	10.66%	-39.11%	11.49%	19.17%	22.64%	15.17%
S&P 500	15.61%	19.26%	-6.91%	-5.43%	1.02%	-0.15%	-37.00%	5.49%	15.79%	4.91%	10.88%

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Performance Disclosure

Prior to June 1, 2004, performance returns were owned by Assante Asset Management Ltd ("Assante"). Tetrem has concluded that these returns meet portability requirements and as such, have been linked with Tetrem's returns for the sole purpose of providing supplemental information to the Tetrem's Composite Performance Presentation. This information is provided to present a longer track record using records available to Tetrem and may have limited usefulness.

**Canadian Equity and U.S. Equity** returns from January 1, 1997 to December 31, 2003 are based on an audited equity-only (excluding cash) composite of all segregated accounts and are owned by Assante. Performance from January 1, 2004 to December 31, 2004 is based on an unaudited equity-only (excluding cash) composite of all segregated accounts. The calculation of performance returns excludes expenses and is based on a monthly valuation using the Modified-Dietz methodology. Returns from January 1, 2005 to September 30, 2009 are gross of management fees and prepared using time weighted rates of return using the Modified-Dietz methodology.

**Canadian Equity Plus** returns from January 1, 1998 to May 31, 2004 are calculated using the audited NAV per share of a representative account within the composite. The NAV per share excludes management fees and is net of operating expenses. Performance returns for this period are owned by Assante. Returns from June 1, 2004 to September 30, 2009 are gross of management fees and prepared using time weighted rates of return using the Modified-Dietz methodology.

**U.S. Equity Plus** returns from January 1, 1998 to May 31, 2004 are calculated using the weekly NAV per share, closest to month end, of the sole account within the composite. The NAV per share excludes management fees and is net of operating expenses. Performance returns for this period are owned by Assante. Returns from June 1, 2004 to September 30, 2009 are gross of management fees and prepared using time weighted rates of return using the Modified-Dietz methodology.

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.

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