*"The markets will always surprise you!"*
***John Di Tomasso, The Di Tomasso Group***

**Last year at this time our newsletter focused on the price of oil and the fact that equity markets seemed to have "shrugged off" the increase in energy and other commodity prices. We skeptically surmised that equity values could not continue to rise under such a scenario. However, here we are one year later with oil prices approximately twenty per cent higher than last year and the TSX has indeed increased. As one of Canada's best money managers, John DiTomasso says "the markets will always surprise you!" In fact the TSX Composite Index is up 29.34% for the year ended September 30, 2005 and 20.67% for the first nine months of this year. On the surface these returns look quite impressive and far outshine our modest returns in 2005.**

**Many of you are wondering why our returns are modest while the Canadian market has returned over twenty per cent this year. The discussion below explains how this year's index returns were achieved. In summary, most of the returns were generated by energy stocks; a group that we believe to be extremely overvalued based on historical norms. The rest of the market returned just 2.5%. In this context our returns seem more reasonable with substantially less risk.**

**Table 1 below shows the returns for the three most heavily weighted groups in the TSX. These three sub-indices made up approximately seventy five per cent of the total value of the TSX Composite Index. Diversification is not one of the TSX's strong suits!**

**Table 1**

**TSX Composite Weighted Return by Sub-Index[1]**

| | 9 months Ended Sept. 30, 2005 | 12 months Ended Sept. 30, 2005 |
|---|---|---|
| TSX Composite | 20.67% | 29.34% |
| Energy Sub-Index | 66.86% | 78.91% |
| Financials | 14.95% | 23.85% |
| Materials | 4.97% | 8.36% |

**Table 2 calculates the weighted contribution that each of the three sub-indices noted above made to the TSX Composite Return. The financial, energy and materials sub-indices comprise 30.77%, 27.07% and 14.27% of the total value of the TSX Composite Index respectively. For example, for the nine months ended September 30, 2005 the Energy Sub-Index returned 66.86% and its weight in the TSX was 27.07%. Multiplying the energy sector's year to date return by its weight in the index gives us the contribution to the broader index return (66.86% x 27.07% = 18.10%). As well, Table 2 calculates the percentage contribution to the TSX's return for each sub-index. As an illustration, the year to date weighted return of the financial services sector was 4.60% while the TSX Composite Return was 20.67%. As a result the financials made up about 22% of the overall return (4.60% divided by 20.67%).**

[1] Source: TD Securities

**Table 2**

**Weighted Contribution to TSX Return from Sub-Indices**

| | 9 months Ended Sept. 30, 2005 | % of TSX Return |
|---|---|---|
| Energy Sub-Index | 18.10% | 87.57% |
| Financials | 4.60% | 22.25% |
| Materials | 0.91 | 3.43% |

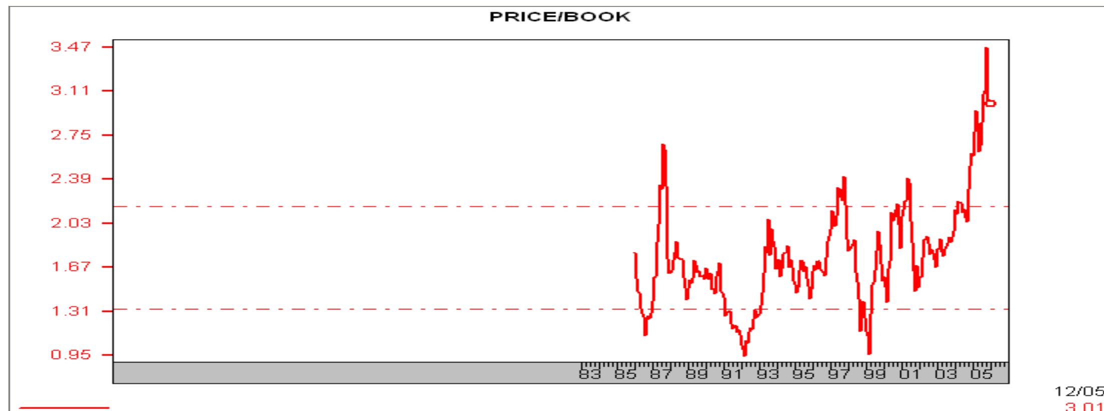
**Not all is as rosy as it seems! As you can see from the table above almost 88% of the Canadian market's return came from the energy group this year. In other words, the remaining 73% of the Canadian market returned only 2.57%!**

**Canadian equity returns excluding energy are more in line with the broader based U.S. equity indices. During the first three quarters of 2005 the S & P 500 increased 2.77% while the Dow Jones and NASDAQ recorded small losses of 1.99% and 1.57% respectively.**

**My partners Gary Sharpe and Mike Nadal often state that client behaviour is the most significant determinant of long term returns. The forgoing discussion is so disconcerting for this very reason; many Canadians are making investment decisions without truly appreciating the nature and composition of the Canadian equity market's return this year. Some are elated that their portfolios did so well and may be committing more funds while others are disappointed and may be reevaluating their current strategy.**

**We have maintained for some time that energy shares are very expensive and trade above their net asset value based on our long term assumptions for oil prices. As the chart below indicates the TSX Oil and Gas Sub-Index is trading at all time high valuations.**

**Price/Book Value of TSX Oil & Gas Sub-Index**




**Source: C.P.M.S.**

**In order to justify such valuations the price of oil must stay at current levels or rise higher. Should oil prices start to fall then energy shares will decline quite sharply. In addition, because the TSX is so heavily weighted in energy stocks it will also likely decline in value.**

**We have also consistently maintained that rising equity values and stable economic growth are not sustainable in the face of record energy prices. If energy prices climb even higher equity markets may experience some turbulence. Not surprisingly the persistently high prices of oil and other basic commodities have started to raise concerns about future economic growth and inflation.**

**We are often asked about income trusts; a very popular investment vehicle peculiar to Canada. We have studied several income trusts and have concluded that the vast majority are not suitable for the long term investor. Again markets have surprised us! Income trusts have provided very strong returns over the last three years.**

**Income trusts have been promoted as income vehicles to investors; particularly those on fixed incomes. Thus the income trust model makes the implicit promise that distributions**

**can be sustained without decline or interruption over a long period of time. In our view, there are very few businesses that can actually keep this promise. The ideal income trust should have all of the following characteristics:**

- **dominant market position in its major product line**
- **stable revenues and cash flows**
- **very low capital expenditures**
- **little or no debt**

**In our analysis of income trusts we have found very few that have all of the above business characteristics. We expect that at some point the distributions of many of these businesses will be reduced. As well, we believe that most resource based income trusts are extremely risky and are returning capital as opposed to income. Distributions in those businesses will decline when the commodity price declines.**

**Income trusts have also increased in value because interest rates have declined. In effect they have behaved like fixed income instruments; rising as interest rates fall. It should follow then that as interest rates rise income returns should at best be muted.**

**In our view, the combination of unsustainable distributions, very high valuations and rising interest rates spell the potential for a substantial loss of capital in the future.**

**As we have explained in the past, our disciplined investment process focuses on earning substantial long term returns while minimizing risk. Today as we search for investment opportunities we continue to find that risk far outweighs reward; particularly in the Canadian markets. However, we are "keeping our powder dry" as we patiently seek out investments that meet our very high standards of quality and safety. Perhaps some day the market will surprise us and provide us with ample opportunities to invest your portfolios in businesses that will generate excellent returns over a long period of time.**