

Quarterly Investment Newsletter

Third Quarter 2008

Catharsis?

In recent months we have experienced some of the most dramatic shifts in markets in decades. A number of well-known global banks and brokers have failed or been taken over. In the week to October 10th, global markets fell by an average of 20%. Concerns about a recession have shifted from denial to certainty. Credit markets have seized up more than at any time in recent history. It has been a very unsettling period.

We have been writing about this economic and credit cycle and the potential market risks in previous newsletters and communications. We will briefly cover the background and the transmission mechanism for the problems and then turn to the policy responses and what is priced into markets at this time.

Root causes

The current down-cycle was ultimately triggered by the sustained period of global monetary tightening, which began in 2004, and extended into 2007. For some monetary authorities, notably the European Central Bank (ECB), policy was only eased in September this year. Central banks raised short-term interest rates; this eventually resulted in these rising above long-term rates, or inverting the yield curve, thus crimping bank profits. Money supply gradually slowed down. Consequently the cost of credit also rose. As the US dollar fell for over four years, the currencies of its trade partners, particularly Canada and Europe, became uncompetitive, and Asian exporters also saw their margins crimped. By the

spring of 2007, classic signs of a US recession were apparent to us, with high risks of this becoming global.

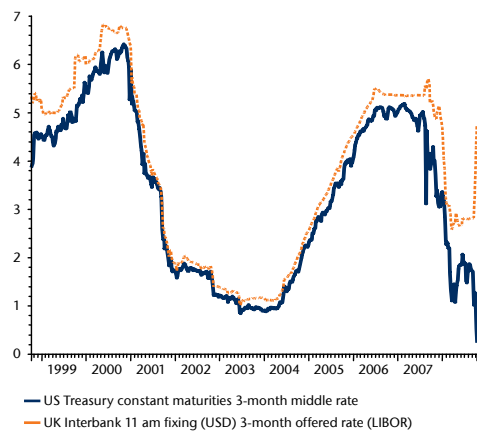
However, to compound the problem, the last years of the US housing boom in 2005-2007 were largely financed by sub-prime mortgages, with huge volumes being extended to poor credit and most re-distributed globally via mortgage-backed securities (MBS). This contributed to a material increase in leverage in financial firms around the world. When the increased pressure from monetary tightening finally hit borrowers in floating-rate mortgages in 2007, the market for new loans collapsed, just as house sales prices began to fall, and defaults on the sub-prime paper soared beyond previous loss rates. This has resulted in extensive losses to financial firms heavily exposed to the sector; in September and October alone the likes of Fannie Mae, Freddie Mac, Lehman Brothers, and AIG, have folded or been merged into other banks in the US. In Europe, several over-extended mortgage lenders have been entirely or partly nationalized in the same period. The common theme was large exposure to sub-prime in the US or Europe, or other excessive leverage in their operations.

“Unsure who would be next to fail, banks, brokers and other financial institutions effectively stopped lending to each other”

Notably only one of these institutions was allowed to go bankrupt without private or public sector support: Lehman Brothers. Lehman was a major player in the mortgage securities business, but also in Credit Default Swaps (CDS), a market used to protect against bond defaults. Lehman's failure in September sparked a further widening in credit spreads on corporate and interbank lending that spiralled into closing almost all credit markets. Unsure who would be next to fail, banks, brokers and other financial institutions effectively stopped lending to each other. The cost of lending money between banks overnight rose to over 400 basis points above the Fed Funds rate, a record spread. Similarly, corporate bond yields rose to yield 300 basis points over government bonds even for high quality issuers. In effect, fear gripped credit markets and immobilized them. AIG bondholders immediately were supported by the US Government, which effectively nationalized the company. The remaining investment dealers, dependent on short-term financing, sought refuge in a bank takeover (Merrill Lynch) or converting to bank status (Morgan Stanley and Goldman Sachs), with the former seeking a capital infusion from Mitsubishi UFJ, the largest Japanese bank, and later receiving government capital.

By the middle of October, markets were looking at a breakdown in credit markets globally; material systemic risk to the US and European banking systems; the risk of global recession rising to a near-certainty; and equity markets in sharp decline, on fears of a downward credit spiral.

Interbank lending expensive



Borrowing costs for banks have risen sharply compared to US Treasury bill rates: easing up conditions in the interbank lending market is crucial

Source: Thomson Datastream

“We have finally begun to see a realistic assessment of the extent of the problem in both policy and market terms”

Paradoxically, as fear has gripped markets and policy makers have scrambled to respond to the crisis, we have finally begun to see a realistic assessment of the extent of the problem in both policy and market terms. This does not mean that “happy days are here again”, but it does mean that the extent of the problem is being framed, and realistic outcomes finally discounted in markets.

Policy Response

Until the last few weeks, the policy response by the US Government, while well-intentioned, has been piecemeal, dealing with one problem at a time, and lagging the developments. The UK and Europe have until the last few weeks been even further behind the curve. We do not believe that Canada has anything like the extent of challenges of our brethren, but again, authorities have been relatively complacent in the face of rising pressures. The slowness of the response has been accelerated dramatically in recent weeks in the face of market turmoil.

There has been a spate of policy announcements during September and October to deal with the seizure of credit markets. These policies encompass a number of key initiatives, on both sides of the Atlantic.

These policies draw upon the experience of previous credit cycles, with plans which ultimately helped to re-open credit markets. In the 1990-92 cycle, also featuring excessive lending on real estate and the ensuing loan losses, bank failures and recession, governments in the US and Scandinavia nationalized parts of their banking systems, extended emergency credit and worked through impaired assets to avoid a larger collapse. The failure of Japan to deal with its similar banking crisis in 1990 resulted in a multi-year recession and a weak stock market. Similarly, current policy actions take two broad approaches:

1. *Pump liquidity into the credit markets from the central banks*, to enable financial firms to fund themselves more easily during this period. This is part of dealing with the liquidity crisis. However, until September the authorities only dealt with the liquidity issue.
2. *Bolster the balance sheets of key financial institutions*, and if need be underwrite the quality of their obligations so that institutions would have the confidence to lend to each other. This involves tackling the underlying issue in the crisis - solvency – as some important institutions are bankrupt based on current asset values and ultimate losses. A solvency crisis, if left unchecked, turns into a liquidity crisis as institutions are afraid to deal with each other and those most dependent on short-term funding, like the investment banks, are in effect forced to close or merge.

So far, these steps have been announced or implemented:

- The Federal Reserve Board, the Bank of England, the ECB, and the Bank of Canada have issued increasing amounts of short-term funding into the money markets to fund the banks and brokers. However, it is only in the last few weeks that central bank balance sheets have been decisively increased, with the Fed balance sheet doubling. In addition, the central banks cut rates together by 50 basis points, lowering the cost of funding to banks borrowing directly from them. In effect, the central banks have just begun aggressive monetary easing.

- The central banks have implemented programs to allow commercial banks and brokers to exchange risky assets for cash, thus allowing the banks to liquefy some of their balance sheet and trade more freely.
- The US Congress finally passed the Troubled Asset Recovery Plan (TARP), which allows the US Treasury to purchase up to US\$700 billion of impaired mortgage securities and other assets from the financial sector. This will enable the government to absorb some of the credit risk. The implementation of this plan is scheduled to start in November.
- Guarantee interbank lending (now proposed by the UK, European and possibly the US governments), as well as financial longer-term bonds (new financial sector borrowing in the UK, Europe and the US to be guaranteed by governments). The key here is to remove the fear of default in key markets so that the financial system can resume funding in a normal way. Re-opening the interbank market, which provides day-to-day funding, is the first and most important step.
- Guarantee all deposits in the banking system to avoid a wave of withdrawals. This has happened either completely (Ireland and UK) or partially (Europe) and the US Federal Deposit Insurance Corporation has raised the upper limit of its guarantee from \$100,000 to \$200,000.
- Do not allow a major financial institution to fail. The collapse of Lehman Brothers sparked a wave of defaults in the CDS market and pushed AIG to the wall. Subsequently, governments have nationalized key companies rather than risking a string of defaults.
- Encourage healthy commercial banks to buy up their weaker competitors. This has happened in the cases of JP Morgan buying Washington Mutual and Bear Stearns, Bank of America buying Merrill Lynch, Citigroup and Wells Fargo bidding for Wachovia, and BNP Paribas taking over the Belgian operations of Fortis, while Lloyd's of the UK absorbs HBOS.
- Nationalize poorly capitalized institutions. Fannie Mae and Freddie Mac, who between them fund or guarantee half the mortgage in the US, were nationalized early in September. Other institutions in Europe have also been nationalized.

- Underwrite the capital raising efforts of the banking system. First proposed explicitly by the UK government, the US TARP legislation also permits the US to contribute to the capital of financial institutions to strengthen their capital ratios. So far the Treasury has proposed buying preferred shares in nine major US banks, picking them out as clear survivors and winners: we hold positions in many of these selected banks. Credit markets will need both explicit guarantees but also stronger capital ratios if they are to function normally.
- The Canadian financial sector had much stronger capital ratios than global peers going into this cycle. While the sector will suffer credit losses, we expect these to be lower than US and European competitors are facing. We expect capital ratios to remain strong and dividends to be maintained. There is a chance that the Federal Government could be more open to domestic bank mergers in this environment, particularly if any bank shows capital strain. Moreover, the Canadian banks are well positioned to acquire any weaker banks facing failure in the US.

The big fear, echoed in some media, is the risk that we are facing a 1930s-style depression. The key point is that the Depression was triggered by the complete failure of the authorities to stem the series of collapses in the banking system, to inject capital or liquidity into the system, and to cut rates low enough. In effect they failed to pursue the sort of policies already announced, and compounded this by raising trade tariffs globally.

However, it must also be said that the emergency measures announced will not avert recession. The financial crisis has clearly shut down lending to the real economy in many parts of the globe, compounding the recession already begun in North American and Europe. Recent economic indicators show a sharp deceleration to the downside in consumer spending, housing, manufacturing and trade. Credit quality is clearly worsening. Commodity prices have fallen sharply. During the meltdown in equity markets in September and October, cyclically oriented sectors led the downdraft, while financial stocks, particularly the stronger ones which are expected to survive, held up relatively well. We have long expected the cycle to continue weak well into next year: the current crisis makes this a virtual certainty.

What's priced in?

Markets have been impacted by the developments of the last two months, and are still undergoing wide daily movements. As always, we continue to be focused on longer-term developments:

- Short-term interest rates are extremely low, with US treasury bills yielding less than 0.5% for three months. Official interest rates will be cut further, beyond the 50 basis points coordinated cut of October. We anticipate Fed Funds to fall to 1% or below and the Bank of Canada rate to cut as much. Cheap funding for the financial sector remains a must.
- We also expect long-term rates to follow suit, with 10-year yields in both Canada and the States reaching their lows of the previous cycle. Investors will continue to buy government-issued yield in this environment.
- Credit spreads widened to new highs in September and October, running from overnight bank lending to long-term corporate bonds. We believe that these moves are excessive, and that the current spate of policy announcements will help

to stabilize these spreads. The resulting record level of yield over government bonds makes them attractive for fixed-income investors with good credit judgment. However, with the recession worsening in coming quarters, we expect spreads to remain historically high over the next year, and do not look for quick recovery in capital values. However, we are being paid handsomely to wait in both corporate and provincial credits.

- As of October 10th, equity markets had generally fallen 40% from their peaks last year. The average bear market in a recession lasts 18 months and declines 30%; in the major recessions, bear markets have lasted up to 2 years with declines of 40-50%. The current cycle already fits into the latter category. The decline in the last two months has reflected the widening of credit spreads and the sharp decline in the economy. While credit spreads could stabilize at current levels or even bounce back, they will not stage a sustained recovery until the economy does. In addition, earnings are clearly falling globally. As of October 10th, we judge equity markets to be in extreme panic mode, and this can be followed by a sharp, but short-term recovery, with more co-ordinated policy response as the trigger. However, on a one-year view we remain cautious on equity markets and continue to invest in the highest-quality securities in our markets, or securities which are discounting far more difficulties than we expect. On a longer-term basis, equity markets are finally starting to look very attractive.

What has SLI done?

We have taken a more cautious view of the economy and markets over the last 18 months, concerned about a US recession combined with the fall-out of the sub-prime mortgage market. Over this period of time we have:

1. Cut back overall equity exposure in our balanced funds, preserving client capital by investing in bonds and cash.
2. Last year, we moved credit in fixed income portfolios to shorter maturities, so as to be more defensive. In recent months we have begun to lengthen the maturity of credit, with the support of very attractive spreads.
3. Moved equity portfolios to higher quality names and more defensive sectors, again so as to reduce the risk from any major decline.

What next?

“The history of past financial crises shows that similar combinations of policies have, over time, stabilized the financial system”

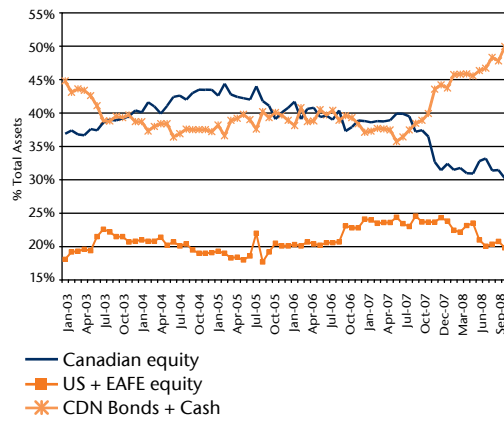
It is still too early to know how effective these policies will be and how quickly they will work. Most of them have just been announced and not yet implemented. Even the prior liquidity injections by the central banks did not let credit and interbank markets to clear. However, specific guarantees of bank debts or shoring up of capital to deal with solvency issues should help, over time, to re-open markets. It is essential to re-open interbank lending, and then mortgage and corporate flows. Markets will key off signs of these improvements in the coming weeks and months. The history of past financial crises shows that similar combinations of policies have, over time, stabilized the financial system.

Going forward, SLI will continue to invest client assets according to their diverse mandates with an eye on capital preservation, high quality and, increasingly, longer-term values that are now being revealed in the market. Above all, we will do so with patience as this credit and economic cycle will not be cured quickly, and with an eye on the long-term returns of our clients.

While it is normal to be worried and nervous in market such as these, and we do not foresee a quick recovery, we would like to leave our clients and readers with a few key points:

- The policy steps taken in recent weeks by authorities around the world are likely ultimately to stabilize the financial system. This will take time, as will an ultimate economic recovery, which again does not surprise us. But policy has historically ultimately been effective, and the right sort of policies is now being beginning to be pursued.
- Credit and equity markets have moved to discounting a great deal of what we would expect in a global recession. Markets have moved from discounting relatively little risk to a great deal in a short period of time. The recovery will take time, probably at least a year, but from a longer-term time frame, many markets, sectors and securities are now extremely attractive.
- SLI has focused on preserving capital in the past year, and will continue to do so. Going forward, we will also be keeping a longer-term investment horizon as we seek out investment opportunities.

SL Diversified Fund



SLI has lowered client exposure to equities and raised bonds and cash positions, so as to protect clients' capital

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