

Transcript for Blue Ribbon / CHIEF H1 2010 Investment Update

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PAUL BLOOM, President, Bloom Investment Counsel Inc.

CHRIS:

Good afternoon and thank-you for joining us today for our Q2 update for Blue Ribbon Income Fund and Canadian High Income Equity Fund. This is Chris Cullen, Senior Vice-President of Brompton Funds. Brompton Funds provides administrative services to Blue Ribbon Income Fund and Canadian High Income Equity Fund.

I'm pleased to be joined today by Paul Bloom, President of Bloom Investment Counsel. Paul, as many of you already know, has over 39 years experience in the Canadian investment industry, and is a renowned specialist in high-income equities, and is the lead portfolio manager for both the Blue Ribbon Income Fund and for the Canadian High Income Equity Fund.

Before Paul and I begin our discussion, I should note that many of the topics that we discuss today may contain forward-looking statements. This information, by its nature, is subject to risks and uncertainties that may cause actual events or results to differ materially

Thanks for joining me today Paul.

To start out, I remember last year hearing a number of economists commenting that the first half of 2010 would be the time frame that an economic rebound would kick in. So, now that we can look back over the first half of the year, my question for you is, has the recovery been as robust as expected? And also, how do you see economic growth continuing in the near term?

PAUL:

On an annualized basis, Canadian GDP growth peaked at a level above 6% over a 6 month period stretching back to October 2009. However, according to the latest set of data, GDP growth appears to have slowed significantly. The data shows a flat return for April 2010 and a decent 3.3% 12 month return given the global economic turmoil during one of the roughest periods in our lifetime. The main culprit of slower growth was retail sales that fell by 2%, wiping out the gains achieved in March. Manufacturing, mining and housing also delivered disappointing results. The earlier exuberant outlook for GDP growth in 2010 is now being tempered. Growth this year of 3.5% is now more likely, and while this is solid, it is below the Bank of Canada's original hopes for economic recovery.

CHRIS:

Paul, many of our clients are attracted to Blue Ribbon and CHIEF because of the high levels of income you have been generating. When it comes to the economy, one of the two issues that these types of clients are most concerned about is interest rates: they want to know "what kind of income can I generate on my investments?". Interest rates have obviously been very low for an extended period, what are your thoughts on current levels and where do you see them going in the near term?

PAUL:

Following the Bank of Canada's June 1st rate hike of 0.25%, Governor Carney's follow-up comments were absent the conviction one would expect if Canada was on a solid footing towards economic recovery. Governor Carney equivocated by saying that "in light of the scale and volatility of these conflicting forces, it should be evident that no particular path for monetary policy is preordained". On the other hand, south of the border, the U.S. Federal Reserve is faced with signs of a further weakening of the economy. This is coupled with core inflation registering below 1% and an oil spill that continues to run amok, particularly for the environment, but also for the economy and President Obama's political stock. These events all leave the U.S. with few reasons to raise rates in 2010.

In Canada, following the June jobs report, the Bank of Canada on July 20th raised rates a further 0.25% to curb the availability of easy access to credit. Indeed, easy lending policies through very low interest rates have driven up the levels of debt carried by Canadian consumers. The Canadian homeowner's equity ratio has been falling over the past three years from its peak of 71.1% in the second quarter of 2007 to around 68% currently. Canadians have been refinancing their mortgages to pay off credit card debt in a similar pattern that bedeviled the U.S. economy. This is a worrying trend, but it puts the Bank of Canada in a difficult position, trying to support economic growth through lower interest rates yet not allowing inflationary spending through easy access to credit.

Having said this, but to answer your question directly we expect short-term interest rates in Canada to increase by a further 0.5% in total by this year's end, and then to perhaps pause until we see evidence of further strength in our economy.

CHRIS:

I mentioned 2 main issues with regards to economics; the other issue concerning our clients the most about the economy is inflation, and how it relates to the purchasing power of the income that our clients are trying to generate. Some commentators on the economy were calling for hyperinflation due to the high level of stimulus that governments pumped into the economy last year. What are your views on inflation now, and moving forward?

PAUL:

Canada's core inflation rate was 1.7%, better than the Bank of Canada's 2% target. Interestingly, only twice in the past decade has Canada's inflation rate been above that of the U.S. In each of these periods a significant price event occurred in Canada causing this unusual circumstance; rising insurance costs and rising commodity prices. Interestingly, both were periods where the Bank of Canada raised interest rates independently of the U.S. Federal Reserve which is similar to the current environment. The price event that we are currently witnessing is the implementation of HST in Ontario and British Columbia and an increase in the rate in Nova Scotia. Consumers will be faced with roughly a 1.3% increase in prices in Ontario and British Columbia as a result of this implementation.

Nevertheless, we do not see inflation in Canada being a serious problem for the next 12 months, or until we see greater economic strength. Longer term – perhaps 2 or more years ahead we are concerned that the massive stimulus provided by governments across the world will lead to significant inflationary pressures.

CHRIS:

As a final comment on the economy, can you give us an overview of the energy segment and how things have been in this quarter?

PAUL:

During the last quarter, the price of oil, as measured by the one year forward strip for WTI in Canadian currency, fell by 4.1%. The Canadian AECO natural gas 12 month strip price, used to help smooth out the seasonality of spot gas prices, rose by 7.7%.

Over the balance of this year we expect oil prices will remain in a range of \$65 - \$85 per barrel. We expect AECO spot gas will continue to firm, due to both seasonality and growing environmental concerns following the B.P. Gulf oil disaster that will see governments restrict new shale gas developments

The key focus in the North American oil markets over the last 3 months has unfortunately been on the Gulf of Mexico oil disaster. This has even caused the U.S. government to espouse the value of the Canadian oil sands. It is expected that Canadian oil sand exports to the US will become the largest single source of US oil imports by the end of 2010. Already in 2009, Canada was the chief provider of oil to the United States surpassing Mexico, Venezuela and Saudi Arabia.

CHRIS:

Thanks Paul. Changing topics slightly, one of the overarching themes you have been talking about this year is the opportunity presented by the ongoing conversion of the Income Trust market, and the emergence of the Canadian High Income Equity market. Can you give us an update on how this is progressing, and any new developments?

PAUL:

The second half of 2010 will see virtually all Income Trusts, other than most REITs, convert to corporate structures. We continue to believe this will create attractive investment opportunities as yield oriented investors gravitate towards this sector.

We continue to believe that as companies convert, their above average yields will attract a new set of investors who were either precluded from buying, or refused to buy former income trusts, especially by those investors that use the S&P/TSX Composite Index as a benchmark. Recent reports by investment dealers have cited the positive impact of index buying on trust names that convert and are added to the S&P/TSX Composite Index. Altagas' recent conversion and the new buying that developed for the ensuing corporation is just the latest example of this trend.

Former income trusts will, we believe, be re-rated upwards once they become corporations as they will be seen to be more attractive than their corporate peers and there will be, especially in the case of larger trusts, substantial index buying as they convert.

Higher income equities will be seen to have a lower cost of capital, which will cause low or no yield corporations to increase their dividends to compete for equally lower capital costs. This, we believe, will cause the sector to expand.

CHRIS:

With respect to conversions, what have the impacts to distributions been in the first half of 2010? How do you see the distribution question continue to play out in the near term?

PAUL:

As we anticipated over the last year, distribution cuts at the time of the conversion of trusts to corporations have, and will continue to be substantially less than most investors had expected. In many cases, when the effects of dividend tax credits are applied, post tax income will rise after conversions by some meaningful amounts for taxable Canadians.

CHRIS:

Let's turn now to the Funds. How has performance for Blue Ribbon and Canadian High Income Equity Fund (or CHIEF as we sometimes refer to it) been over the course of the first half of 2010?

PAUL:

Blue Ribbon:

The fund provided a positive total return performance for the first half of 2010 of 3.3%, outperforming the S&P/TSX Composite Total Return Index's return of negative 2.5%. Since the fund's inception in September 1997 the performance has provided a 12.02% annual compound rate of return versus 6.1% for the Composite index.

The fund's exposure to oil and gas trusts on June 30th was 23.3%. This compared to a 50.2% oil and gas weight in the S&P/TSX Income Trust Total Return Index. The fund's business trust sector (including power, pipes and infrastructure) made up 40.9%. By extrapolation (as there is no specific business trust index) business trusts represented 31.6% of the index. Real Estate (REITs) exposure was below that of the trust index, 13.2% versus 18.25% for the index. Cash represented 22.6% of the portfolio due to the exercising of Blue Ribbon warrants in the last few days of June. We will look to invest this cash as we find good value.

CHIEF:

From the fund's inception date of February 18th, 2010 to June 30th, 2010, the fund's performance since inception was negative 2.4%, which matched the performance of the S&P/TSX Composite Total Return Index.

As of June 30th, 2010, the portfolio held 33.7% in oil and gas related stocks versus 50.2% in the Trust index. The portfolio's exposure to Business Trusts was 41.7% versus 31.6% in the Trust index. REITs represented 24.3% in the fund while in the index they were only an 18.2% weight. We indicated at the time of the fund's IPO that fund would make use of leverage. Net leverage at the end of the quarter was a very modest 1.5%.

CHRIS:

So looking ahead for the funds, and based on your earlier comments about the economy, I'm drawing the conclusion that the North American economy isn't exactly "on fire" right now. Perhaps a better description would be to say that growth has been and is expected to remain "muted"? Can you sum up your views on the economy and the stock markets, in terms of how they will affect the Blue Ribbon and Canadian High Income Equity funds going forward?

PAUL:

We're not expecting to see rapid growth in the economy over the next year, rather a flat to "gentle growth" scenario. North American governments expected to maintain dove-ish policies in an attempt to nurture the fragile recovery.

The natural conclusion for our economic views is simple; the coming period will not be a case of "rising tide floating all boats". One bright spot, and one we have particular expertise in, will be the Canadian energy sector due to its continued rising importance to U.S. consumers.

In the context of my views on the economy and the markets, value-add in the Blue Ribbon and CHIEF funds will be from Bloom Investment Counsel continuing to do what we do best: searching out and investing in undervalued companies, and harvesting those holdings which become overvalued.

We will continue to focus on specific opportunities arising for the Funds in the context of our vision for the emerging Canadian High Income Equity market

Income will continue to be a very important component of equity market returns over the coming year. Indeed we expect a high proportion of returns to come from distributions or dividends, and this we believe makes the Canadian High Income Equity market, in which we our firm specializes, the investment area of choice.

CHRIS:

Thank you, Paul, for your comments and insights today.

Well, that wraps up our H1 2010 investment update for Blue Ribbon Income Fund and Canadian High Income Equity Fund. Thank you for listening. If you have any further questions, please call and ask for me, Chris Cullen, at 416 642-6000 or 1-866-642-6001 and I'll help you out. Have a great day; I hope to speak to you soon.