

Equity update

May 2011

Sentry Diversified Total Return Fund
Sentry Market Neutral L.P.

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CITIGROUP ECONOMIC SURPRISE INDEX VS. THE S&P 500 INDEX: RECENT DIVERGENCE IS QUITE STARTLING



Source: Bloomberg

Market overview

At the beginning of 2011, we expressed the view that markets would be up in the first half and down in the second half, and finish the year with marginally positive returns. We stick by that view today.

Continued stimulus, solid profit growth, supportive retail fund flows and economic data that remain on the positive side of the fence are responsible for the decent tone of the first half. Unfortunately, the performance of the funds year to date has been below our expectations due to incorrect sector exposures (ie., too many cyclicals and a few single-name stocks such as Magna International Inc. and Bioexx Speciality Proteins Ltd.).

We believe markets will face three challenges in the second half of 2011. The most talked-about issue is the pending expiry of QE2 (the

second round of quantitative easing). We foresee three scenarios from this expiration: 1) rates go up a little, which we think would be good for the equity markets, as the markets discount a continuing economic recovery, 2) rates go up a lot, which would likely be bad for the markets, and 3) rates go down, which from the current 3.2% area for US treasuries would imply to us a pretty tough forward outlook for the economy, and hence be bad for equities.

Two months ago, it seemed we couldn't pick up a newspaper and not read how inflation was inevitable and rates were going to rise; so much for that idea. Consensus now suggests that short rates will remain on hold in the US for another five quarters, at a minimum, and perhaps be bumped by another quarter percent by the Bank of Canada. As for 10-year rates, markets are pricing in a 3.95% yield by the end of 2011, a pretty big rise from current levels.

We doubt they'll rise that much because the economy just isn't that robust. The chart at the beginning of this commentary shows the Citigroup Economic Surprise Index versus the S&P 500 Index. The Citigroup Economic Surprise Index is an objective and quantitative measure of economic news. A positive reading of the Surprise Index suggests that the economic releases have on balance beat consensus, while a negative reading suggests the opposite. As demonstrated at the far right of the chart, despite the recent sharp decline in the Surprise Index, the S&P 500 Index has not followed suit. In fact, the S&P 500 has trended slightly up over the recent period. The divergence is quite startling.

To us, the idea of continued low rates validates our long-held view that we're stuck in a tepid recovery and profit growth will decelerate markedly as the year progresses.

Based on the 88% of S&P 500 companies that have to date reported Q1 results, profit and revenue growth has been 18% and 9%, respectively. Looking ahead, we believe we'll see a growing dichotomy between the haves and the have nots.

The haves will be the energy and select mining companies that will benefit from a positive year-over-year bump in commodity and product prices. In addition, we expect good profit growth from marquis companies selling 'demand inelastic' products and services. Some of the companies in this latter group (e.g., Apple) will bias index earnings upwards given their superior rates of revenue growth and super high margins.

However, we believe that beneath these two groups of companies that are likely to power S&P 500 earnings into the mid-\$90s for 2011, will be a growing number of US-oriented companies who will struggle to raise prices to meet the margin expectations of Wall Street. The reason is the state of the consumer.

Jobs are coming back to the US economy, but as of now, wage growth and the number of new jobs won't do the trick. Eighteen months ago, many economists wrote how the US needed to create 300,000 new jobs a month to begin to win back the more than eight million jobs lost during the 2008/09 downturn. The April 2011 report was the most promising monthly jobs report to date, but fell well below that magic mark at 244,000.

Perhaps a more important factor is wage growth. Hours worked has advanced to a +4% run rate, yet real-wage growth remains negative. Combined with the renewed downturn in the housing market and the price of everyday basics, it's tough to see how the broader consumer base will affirm the price hikes that a growing proportion of non-marquis companies will need to maintain margins. As a result, we suspect a growing number of companies will be reporting flat year-over-year sales growth for Q4 2011.

Decelerating earnings growth in an artificially low-interest-rate environment should cause equities to have a tougher second half of the year. To prepare for this scenario, our directional portfolios (not including Sentry Market Neutral LP) are raising exposure to high-yield bonds, cutting back on cyclicals (especially junior and mid-cap names), adding large-cap, dividend-paying internationally focused companies, and growing our base of short positions.

Sentry Market Neutral L.P. and Sentry Select Market Neutral RRSP Fund are available only to accredited investors or those who meet a minimum investment threshold.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. The indicated rates of return are the historical annual compound total returns net of fees (except for figures of one year or less, which are simple total returns) including changes in unit value and reinvestment of all distributions and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any securityholder that would have reduced returns. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.

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