

WELCOME TO A BUSINESS CYCLE

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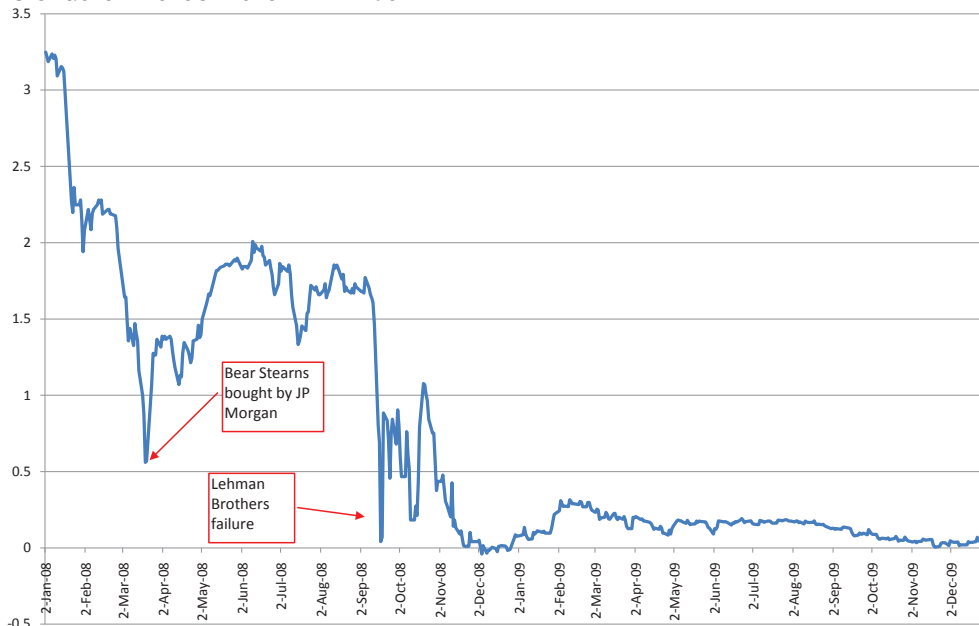
June 7, 2011

April 2011 was the second anniversary of my article “Is there a road to recovery?” In that piece, I looked at a table referring to key metrics that had to be ticked off before you could have confidence that an economic and market recovery were in place. There was also consideration of where we were in the selling process at that point in time. In effect, the first wave of the crisis in autumn 2008 was the result of margin calls. The second wave in February and March was capitulation. What was unclear when I wrote the article was the catalyst for the wave of margin calls.

While on vacation in March, I read a book on Jamie Dimon, the CEO of J. P. Morgan Chase: “Last Man Standing.” In the book, they refer to an unusual run on Lehman Brothers in the week leading up to Lehman’s failure. A primary funding source for Lehman was overnight deposits from capital sources such as State Street, the number one custodian of mutual funds, and Fidelity, the largest mutual fund company. As money market funds withdrew their funding from the banking system, yields collapsed in the short-term US T-Bill market. This withdrawal of liquidity had a material knock-on effect in that the investment banks were also the primary lenders to hedge funds running long/short and levered strategies.

CHART 1: Precipitous decline in yields in September 2008

U.S. Government 3-month T-Bill Index



Source: Bloomberg, Sentry Investments

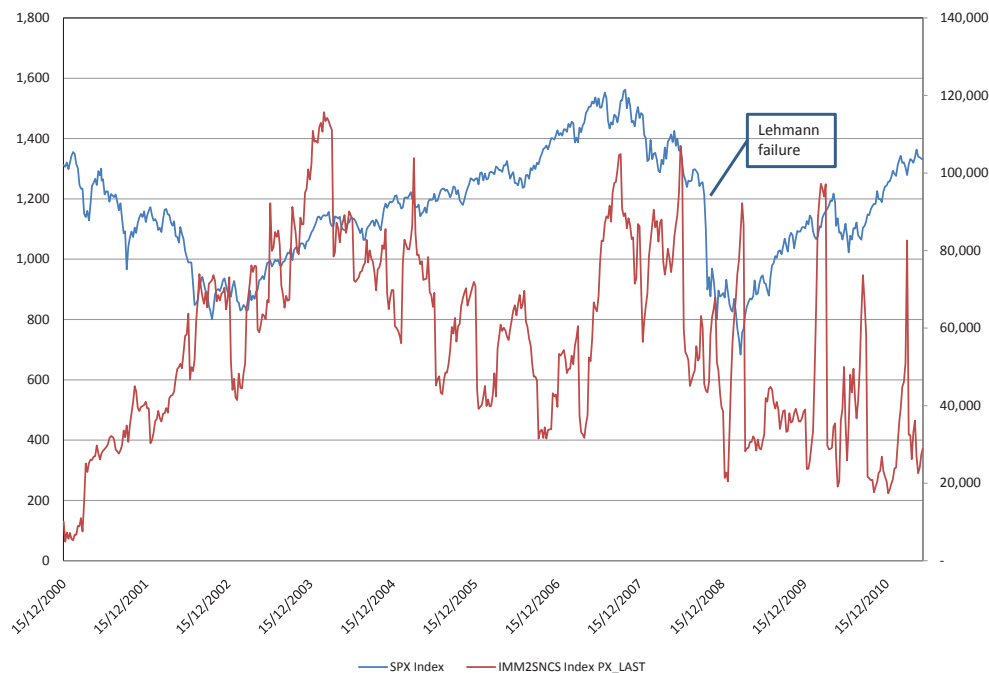
At the start of September 2008, the 3-month T-Bill had a yield of 1.7%. The precipitous decline in yields began the week of September 8th. By the time Lehman filed for Chapter 11 bankruptcy, the 3-month T-Bill had fallen to 0.8% and reached 0.04% on September 17th. With withdrawal in funding for Lehman came concerns about the other investment banks and their liquidity. The margin calls had started.

The role of fast-money investors

In every market cycle, positioning of key players is critical. Slow money (i.e., retail and pension investors) tends to react to market stress in a structural way; investors change their risk tolerance for extended periods. Fast-money investors (i.e., speculators and hedge funds) are direction agnostic and tend to push markets alongside of the ‘then current’ trend. What fast money cannot do is fight a primary trend that is well established and is being funded by slow-money capital flows. You can see in the following chart of short interest in S&P 500 futures that the fast money attacks direction change very quickly; very rarely, though, will it hold a short index position for an extended period. What is also fascinating about this chart is how speculative short interest declined during late September and early October 2008. The fast money did not have margin liquidity to participate in pushing the market to lower levels in October 2008. They did have liquidity again by January and February 2009, and helped drive the market to its ultimate low. They have liquidity today but their positioning is not aggressive.

CHART 2: Fast money moves quickly

S&P 500 Futures: Non-Commercial Short Interest

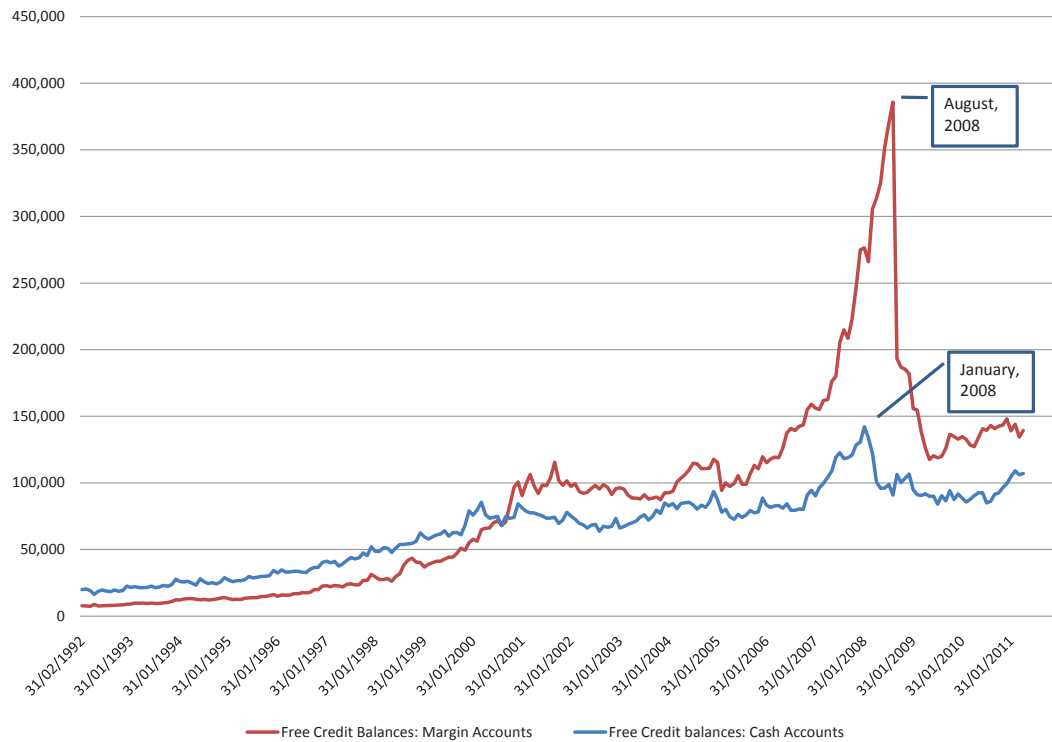


Source: Bloomberg, Sentry Investments

If you look at margin debt and free credit balances in cash and margin accounts in the US broker dealer industry in 2008, you can clearly see the withdrawal of liquidity from the system. Liquidity today in these accounts is good; indeed cash balances in cash accounts at the end of April were the highest since the 2008/09 crisis.

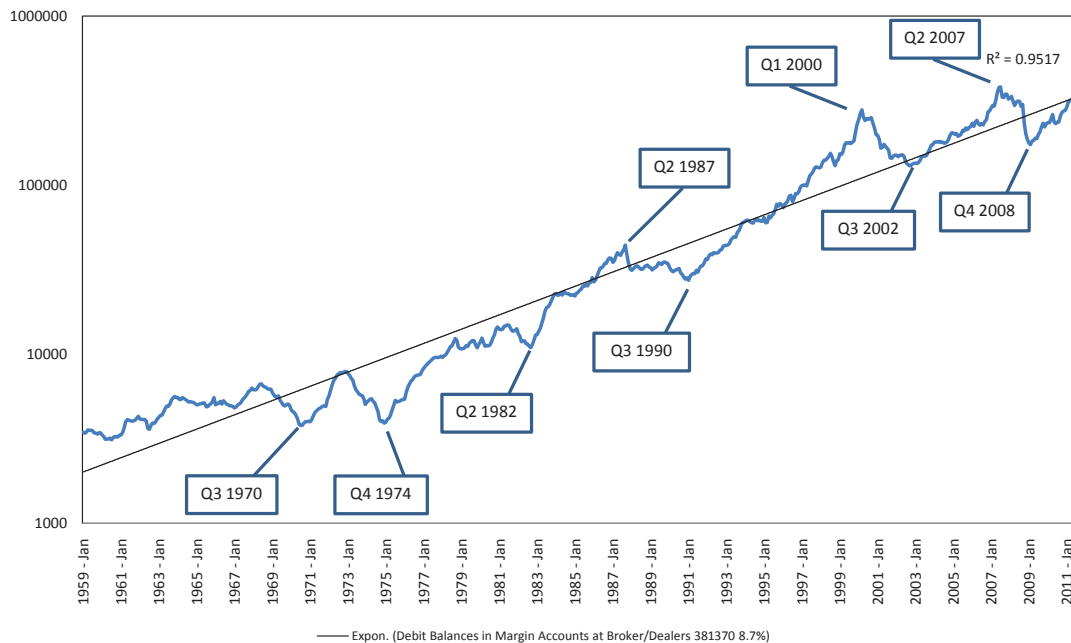
CHARTS 3 & 4: Withdrawal of liquidity in 2008

Free credit balances in cash and margin accounts



Source: Bloomberg, Sentry Investments

Debit balances in margin accounts at broker/dealer \$million compound annual growth rate - 8.7%



Source: New York Stock Exchange, Haver Analytics, RBC Capital Markets, Sentry Investments

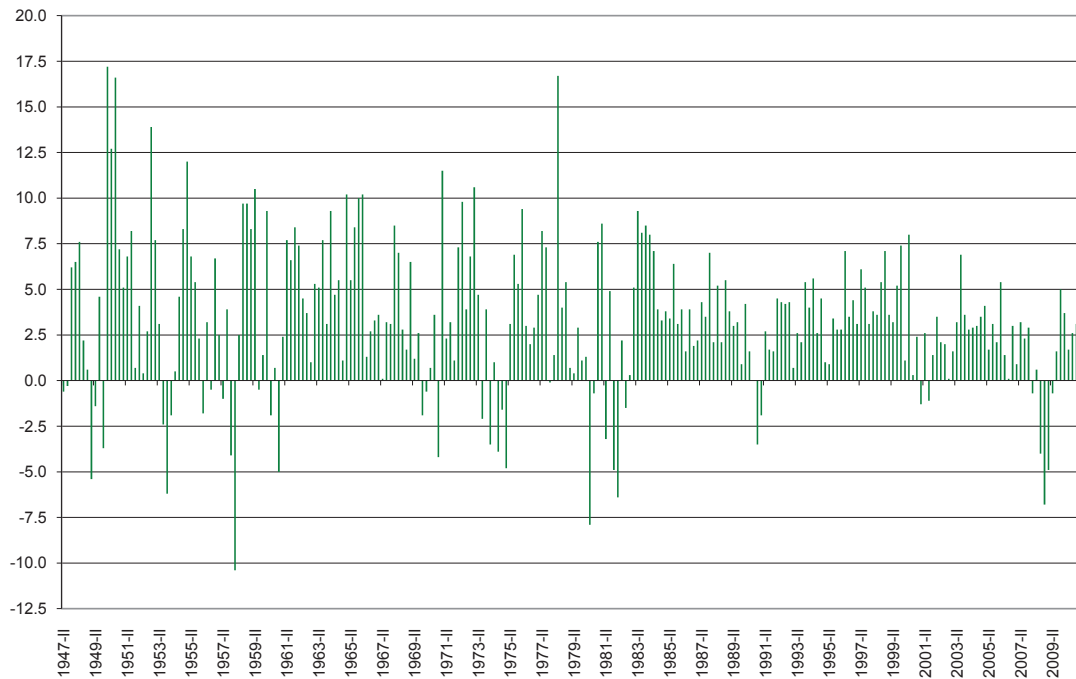
The point of this is that I believe the stock market positioning of major market players today is not aggressive. Individual investors have been investing the bulk of their 401k contributions into bond portfolios. Pension funds sold equities into the bottom in March 2009 and have been holding their asset mix stable roughly at levels last seen in the early 1990s: 55% to 58% equities, and approximately 35% fixed income. Savings are building in the banking system and flowing into bank purchases of government bonds. Major market participants are very cautious. This is the backdrop for a market correction, but not, in my view, the precursor of a major market decline.

Transition into mid-cycle

Within the economy there are stresses evolving in part as a result of high energy prices. This is showing up in weakness in the April ISM Services data and the May ISM Manufacturing as well as recent weakness in global leading indicators. If you look at the ebbs and flows of economic growth, it is never linear. After two years of a strong global recovery, we are transitioning into mid-cycle. With mid-cycle comes a withdrawal of stimulus and normally an initial tightening of administered rates by central banks. The consensus view is that it is very unlikely that the US will tighten before the 2012 presidential election. However, with China tightening, US fiscal stimulus waning and high energy prices persisting, it is very likely that we will go through a period of slowing growth. Indeed some commentators have put forward the contention that the spike in oil prices could lead to a renewed recession. Recent declines in the oil price push that risk onto the back burner for now. As you can see from the quarterly US GDP data, it is very normal to have weak periods within a growth phase.

CHART 5: Weak periods within a growth phase are normal

US quarterly percent change in real gross domestic product



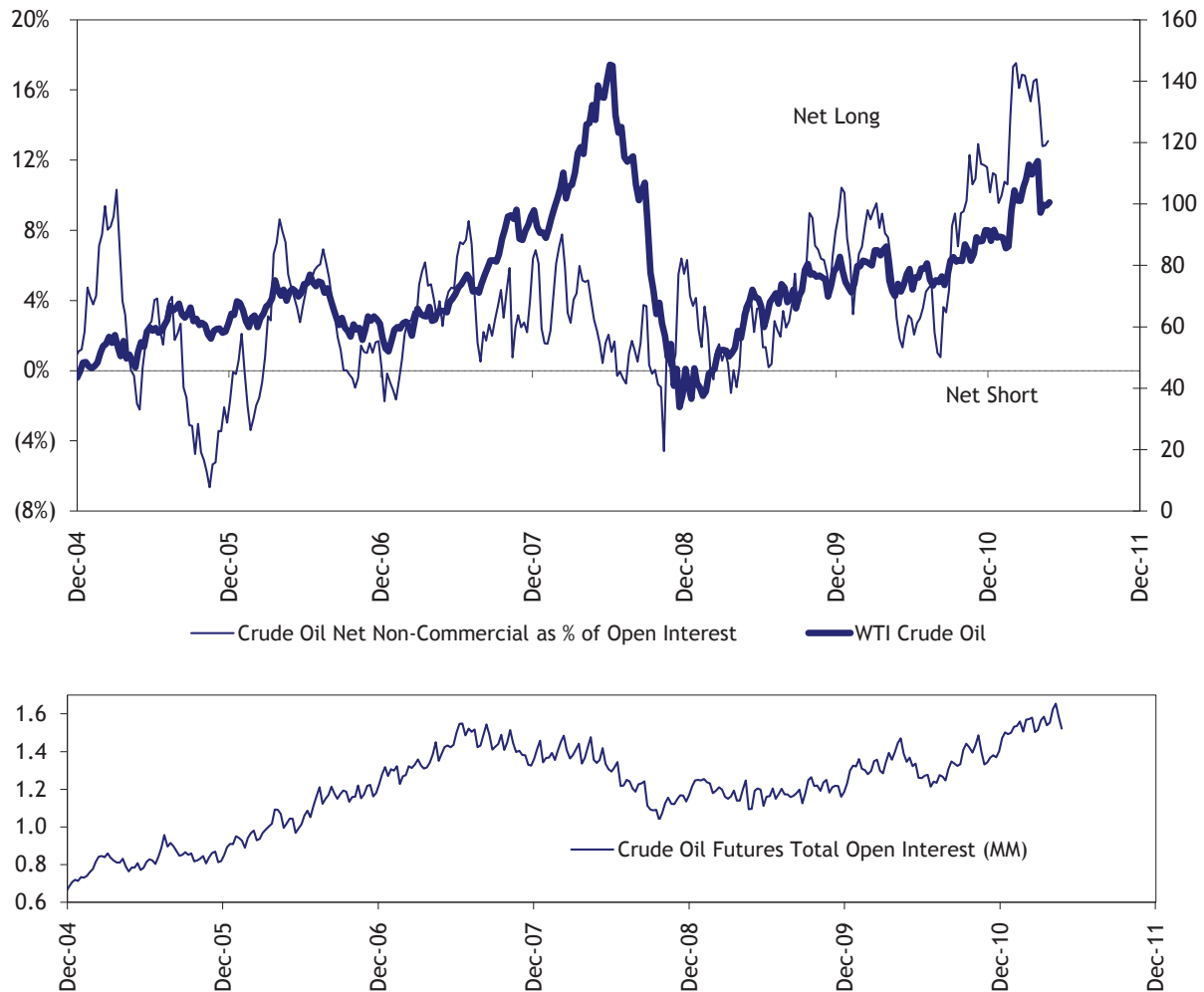
Source: US Bureau of Economic Analysis, Sentry Investments

In my view, the major risks today are not in quality equities, but in what passes for “established wisdom” about the impact of US quantitative easing. In my travels, the most consistent questions from investors and advisors deal with QE II (second round of quantitative easing) and its ramifications. In most cases, they are looking for validation of their decision to focus on commodities and commodity stocks as “beneficiaries” of quantitative easing.

Divergence between commodity and commodity equity prices

The risk for the market, I think, lies in this belief system: the US is printing hyper-inflationary dollars that will drive the US dollar into the ground, and commodity prices and inflation to the moon. Commodity prices are now being set on Wall Street rather than in the real economy of supply and demand. Not only are speculators buying oil futures contracts in record amounts, they are funding the purchase by selling US dollars short. When the US dollar stopped declining and rallied a couple of weeks ago, margin calls forced sales of oil futures and short covering in the currency markets.

CHART 6: Commodity prices are being set on Wall Street
 Crude oil futures net speculative position $[(\text{long}-\text{short})/(\text{open interest})]$



Source: Bloomberg, Sentry Investments

The sharp increase in net long futures contracts as a percentage of open interest between February and April helped drive West Texas Intermediate (WTI) pricing up by a third. Changes in margin requirements that prompted a small decline in the net long position resulted in a fall in WTI of 15%. What happens when this very crowded trade in futures attempts to unwind? Pain. Despite recent declines, total open interest remains at record levels. It is worth noting that energy equities broke from the commodity back in February, led the TSX to the downside in this current correction and have recently begun to find support around the 200-day moving average. At current prices, both oil and natural gas businesses are prospering.

CHART 7: Energy equities finding support around the 200-day moving average



Source: Bloomberg

This break between the behaviour of the commodity and equities was also happening in the gold sector. Despite the commodity attaining new highs in US dollars last month and euros last week, gold equities are also testing support. Indeed the Philadelphia Gold Index is little changed from mid-2008 levels while the commodity is up almost 60%.

CHART 8: Gold equities testing support at the 200-day moving average



Source: Bloomberg

Within the commodity complex, differentiation must be made between those commodities that depend on economic growth for their value (i.e., consumables) and those commodities that can act as currency (i.e., gold and silver). Consumables in my view do not provide portfolio diversification. They are as dependent on the economic cycle as equities but have major drawbacks; they do not provide cash flow until they are sold and they cannot provide unit volume growth. Currency surrogates do provide portfolio diversification and the equities that produce currency surrogates can provide unit volume growth.

Risk of sovereign defaults

As with any business cycle, there is going to be speculation as to the duration and strength of the cycle; when concern over the durability of the cycle predominates, equity markets will periodically stumble. Today the risk of sovereign defaults and deficits dominate the headlines. Sovereign defaults are a fact of life and are directly attributable to lending booms and busts. There is a fascinating extract from an article titled “Sovereign Defaults and Debt Restructurings: Historical Overview” at <http://mitpress.mit.edu/books/chapters/0262195534chapm1.pdf>.

There is a distinct clustering of defaults with the greatest number occurring after a significant global financial shock that was preceded by a period of global prosperity. The most comparable periods are 1931 to 1940, during which there were 25 defaults/restructurings, and 1976 to 1989, which witnessed 56 such events. In each period, Latin America and peripheral Europe were hot spots for default. In the

1976 to 1989 period, Africa was prominent with 23 defaults/restructurings. The causal effects may have been different between the two periods. What was not different was that during both periods, commodity-producing countries with undiversified economies dominated the default list. What is also clear is that lending excesses were made in a prior economic cycle and the pain came during an economic recovery from a major downturn. In each case, the recovery may have been protracted but it did not appear to derail global economic expansion.

The importance of basic investment principles

Regardless of the period, some basic investment principles should dominate. Remember that capital is in constant formation: personal and corporate savings, pension contributions and personal retirement plans all are in growth mode. All are looking for acceptable investment returns with tolerable risk levels.

For fixed-income portfolios, the key questions are: Does the creditor have the capability of repaying the debt? Is the term appropriate for the business risks to which the creditor is exposed? Is the risk premium suitable for the desired inflation rate of the country in which the company is domiciled? All fixed-income investments should include an appropriate risk premium for the desired level of inflation. When the risk premium is too low, be cautious. We believe the risk premium in US and Canadian government debt is too low for the long-term inflation rate of 2% desired by the central banks. Indeed, our preference is that the debt of companies located in fast-growth economies be denominated in US dollars.

For equity portfolios, preservation and growth in capital is the prime objective. Expert valuation is the key to paying a fair price for the opportunities we see in an investment. Once we are positioned, we actively monitor companies for changes in capital structure, changes in return on assets, capital and equity. Risk is reduced through diversification across asset classes and through a thorough understanding of the unique risk characteristics of different industries. Our goal is to add alpha to portfolio returns while reducing the natural beta of market volatility. To quickly measure relative risk between industries, we have created a new ratio, Volatility: Return on Equity.

CHART 9: Volatility and ROE characteristics for the TSX

	Mean 30 day volatility	ROE 1 year trailing*	ROE trend**	Volatility: ROE Ratio	Dividend yield
High Beta Sectors 51.5%					
Energy	24.60%	8.20%	Falling	3	2.39%
Materials	26.90%	11.80%	Rising	2.3	0.60%
Info Tech	38.60%	33.40%	Rising	1.2	0.11%
	26.20%	10.90%		2.4	1.51%
% above (below) index	39.00%	-14.40%			-37.60%
Financials 29.1%	17.50%	14.20%	Rising	1.2	3.66%
% above (below) index	-7.10%	12.70%			51.20%
Low Beta Sectors 19.3%					
Industrials	19.30%	15.30%	Rising	1.3	1.91%
Cons discretionary	14.40%	16.60%	Rising	0.9	2.87%
Telecom	18.80%	19.60%	Falling	0.9	5.05%
Cons staples	11.80%	14.00%	Falling	0.8	1.83%
Utilities	13.40%	8.90%	Falling	1.5	4.77%
Health Care	22.50%	4.70%	Falling	4.8	1.11%
	16.90%	15.10%		1.1	2.89%
% above (below) index	-10.40%	20.00%			19.40%
S&P/TSX	18.80%	12.60%	Rising	1.5	2.42%

Source: *CIBC World Markets ** CIBC World Markets April 2002 to April 2011

Any investor should approach sectors or companies that exhibit high volatility, low ROE and low dividend yield very differently from companies that have low volatility, high ROE and high dividend yield. It is our unique approach to the commodity sectors that has resulted in Sentry Precious Metals Growth Fund winning seven Lipper Awards. The unique approach is also evidenced in the outstanding returns for Sentry Energy Growth and Income Fund. In a sector known for volatility in both price and ROE, our discipline has led to outperformance with less volatility. Over the year ending April 30, 2011, Sentry Energy Growth and Income Fund had a beta relative to the S&P/TSX Energy Index of 0.53 and an upside capture of 92%, while experiencing downside capture of 39%.

Earlier in this article, I discussed some of my concerns regarding commodity investing and the pressure on commodity prices from speculators; they are taking levered bets on the price direction of an underlying commodity. Frequently equity investors will look for “commodity leverage” in their stock selections to make a levered bet on the underlying commodity. Our approach highlights the fact that you do not have to take excessive risks to earn decent returns while investing in commodity equities.



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