

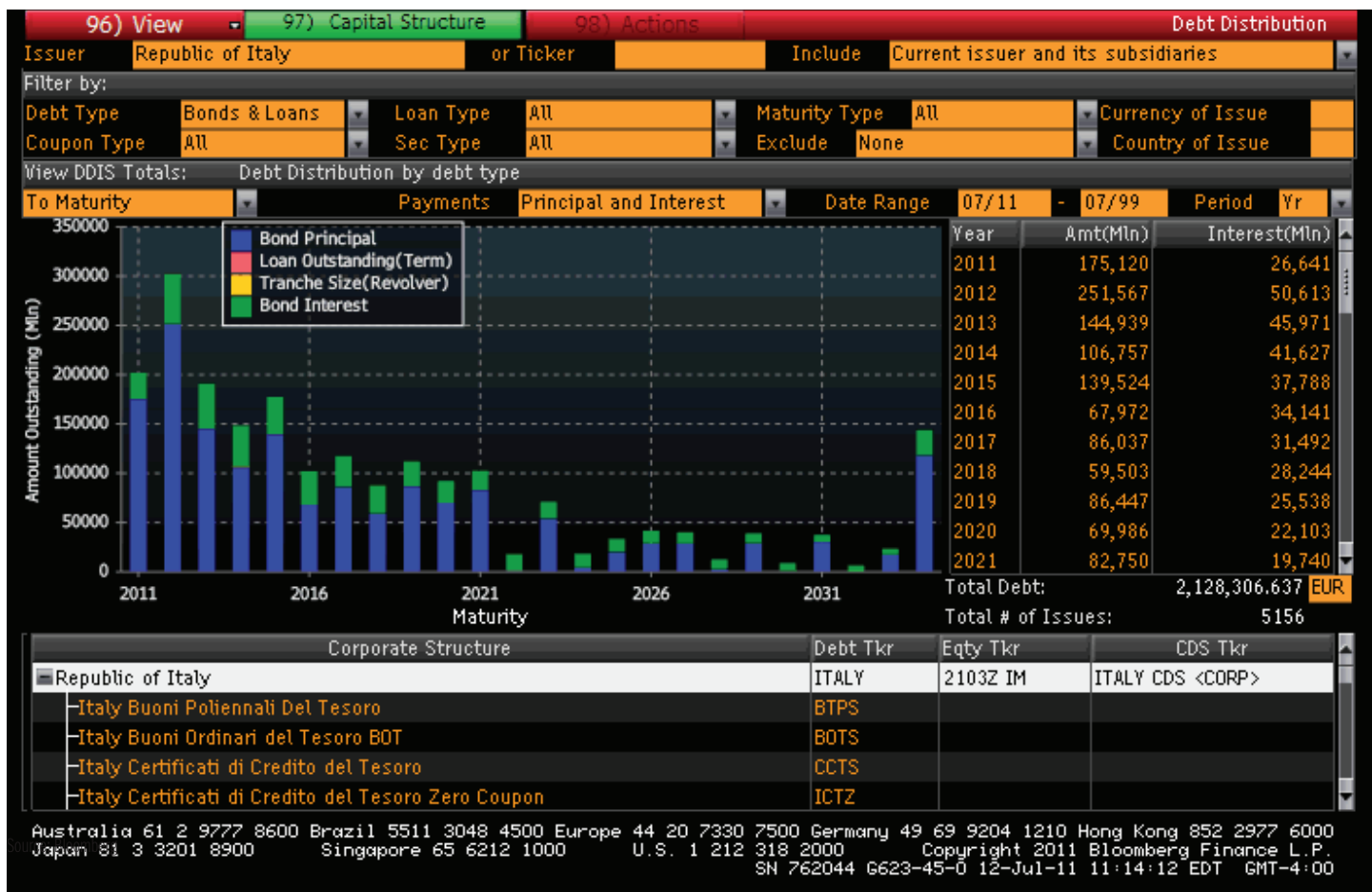
Equity commentary

July 2011

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

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ITALY'S DEBT WOES: NEARLY €900 BILLION TO REFINANCE OVER NEXT FIVE YEARS



Source: Bloomberg

Market overview

It's been almost three years that equity markets have benefited from low interest rates. With the record level of leverage that's in the global system today, we can be thankful that they remain low. Rising interest rates could be a calamity for some countries, let alone financial markets.

Italy, for example, already spends more than 10% of GDP on interest payments. Over the next five years, Italy must refinance nearly €900 billion of debt to finance its current debt: GDP ratio of 120%. Given market conditions, that's bad enough.

What makes it worse, however, is that PM Berlusconi is in a very public dogfight with Finance Minister Tremonti, who refuses to acquiesce to Berlusconi's demands for tax cuts. Hence the more than 50 basis point leap in Italian bond yields last week that has put interest rates at 9-year highs. Sounds like the 10% figure could march toward 15%.

The same dogmatic scrap is going on in the US, as evidenced by Boehner's refusal to continue talks with Obama, again over taxes. The crime in all this political posturing is what it's doing to "the common people" – they can't find jobs. In the US, for every opening, there are seven individuals competing for that job.

A couple of years ago, I penned a market commentary entitled, "It's All About Jobs," and the song remains the same today. With 125,000 folks entering the US workforce every month, the job market is shockingly bad. There are fewer jobs in the US today than there were more than 10 years ago. The participation rate is the lowest it's been in almost 30 years. And, by the way, last month's wages and hours worked both declined modestly.

In addition, the US housing market is still deteriorating and it's no surprise to anybody that food and energy prices are more than a

problem. In fact, the lowest quartile of US households (by income) has recently spent as much as 35% of its income just on food.

In developed markets, life is rougher today than it was 12 or even 36 months ago for the vast majority of the population. Wait until interest rates go up!!!

Fortunately, interest rates shouldn't rise for a while. US banks, retail investors and central banks continue to pile into bonds. That's why even renowned bond manager Bill Gross has yet to be right on his call to sell bonds. It will happen, but not yet; in fact, probably not for another year or more.

All the problems discussed above ensure that we should continue to be in a square root recovery – an economy whose rate of growth is stuck in a below-trend rate of growth for a very long time. In fact, so stuck that the continued “pushing the problem down the road” that most policymakers continue to engage in, is completely pointless. The piper will have to be paid – the only question is when.

For the record, I believe that begins in calendar 2013, when the “lucky” new President of the US tables his/her budget for fiscal 2014. Cognizant that the World Bank will be correct in its call that the US dollar will only be one of three reserve currencies entering 2020 (RmB & euro being the other), the US will have to begin getting its fiscal house in order. My bet is that the President will table budget changes equivalent to 1% of GDP for the following five years.

But with baby boomers desperate for income and interest rates staying low until the supply/demand dynamics for bonds cause rates to rise, equities will continue to have a decent bid. However, as evidenced by the challenging market environment year to date, low interest rates don't guarantee the one-way trade that equities were post March 2009.

Portfolio update

I'm thankful that we've entered the second half of the year. I had a rough first half for two reasons. First, I did not have the macro trade of the year on, specifically short commodity stocks and long income stocks. Second, I've had some stock calls that haven't worked out.

Entering the second half of 2011, I have made a few adjustments to the fund that has a directional orientation, **Sentry Diversified Total Return Fund**. Bonds have been boosted towards a 20% allocation, all high-yield, including half to emerging markets. If US rates get low enough, there'll be a point where I am likely to short some US Treasuries against my position in high-yield bonds.

Income-oriented stocks now total approximately 20% of the Fund, with an additional 10%+ exposure to North American bank stocks. On the other hand, I've cut the weight in resource stocks, specifically

energy and metals, especially on the small-cap side, though not the underperforming gold sector, which sits around 12%. US stocks total more than 15% of the Fund, while cash currently sits above 20%.

The other change in the Fund has to do with an addition to our team. Ashley Kennedy, CFA, joined Sentry towards the end of May 2011. With several years of experience as a member of a recognized hedge fund team, Ashley has already made a strong mark on our team.

Our short positions now total 15%, and this has been accomplished via adding a large basket of small weight positions in companies with targeted characteristics.

The positioning of the non-directional **Sentry Market Neutral L.P.** is generally indifferent to market conditions. The rationale for such a statement is driven by the fact that the majority of the positions in this Fund are same-sector paired trades, where the goal is to hedge out the beta and isolate the alpha.

Earlier this year, modest net long exposures to underperforming commodity sectors hurt the performance of the Fund, while recent losses are the result of a couple of special situations.

I look forward to “the fight” in the second half of 2011, and delivering a good year to my investors, but will not stray from my “tortoise beats the hare” style of investing.

Outlook

As of June 30th, Canadian equity indices are down a tad and US markets are up a bit. I suspect the second half will continue to be “adventuresome”.

When the US economy shows itself by Labour Day to not be as weak as shown by the May/June data, equity markets will likely get a boost. Similar lifts could occur on events such as a resolution of the debt ceiling in the US and, of course, Greece. On the other hand, because of the aforementioned economic challenges facing the majority of the population, I foresee a very marked deceleration in earnings growth for a majority of non-energy companies and issuers who sell price-inelastic products or services. I believe these guidance cuts will serve to take away much of the good news mentioned just beforehand.

In other words, investors are going to have to navigate carefully through the remainder of 2011, but it should all be okay, for now.

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. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.

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