REIT/Infrastructure commentary

October 2011 (Data as at September 30, 2011)

Sentry REIT Fund
Sentry Infrastructure Fund

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ECONOMIC DATA

	CANADA	US
OVERNIGHT RATE/FED FUNDS RATE	1.00%	0.25%
PRIME RATE	3.00%	3.25%
5 YEAR GOC/UST YIELD	1.39%	0.95%
10 YEAR GOC/UST YIELD	2.15%	1.90%
2011 GDP GROWTH EST.	2.40%	1.70%
2011 INFLATION EST.	2.70%	3.00%
SPOT EXCHANGE RATE	$0.9540/$1.0482	

Source: RBC Economics

MARKET INDICES

	LEVEL	YTD
S&P/TSX CAPPED ENERGY INDEX	241.59	-25.39%
S&P/TSX CAPPED UTILITIES INDEX	226.36	1.39%
MSCI US REIT INDEX	698.52	-9.95%
S&P/TSX CAPPED REIT INDEX	145.78	8.42%
S&P/TSX COMPOSITE INDEX	11,623.00	-13.27%
S&P 500 INDEX	1,131.42	-11.04%

Source: Reuters, price returns

BNN TOP PICKS

MAY 26, 2011	
PRIMARIS REIT	$20.73
CANADIAN REIT	$33.60
DUNDEE REIT	$33.47

Source: Sentry Investments

BEST MONTHLY PERFORMERS

SENTRY REIT FUND		SENTRY INFRASTRUCTURE FUND	
CHARTWELL SENIORS HOUSING REIT	5.89%	BROOKFIELD RENEWEABLE POWER	10.69%
CANADIAN REIT	2.53%	GWR GLOBAL WATER RESOURCES	10.00%
RIOCAN REIT	2.32%	TRANSURBAN GROUP	4.43%

Source: Reuters

REAL ESTATE VALUATIONS

	CANADA	US
MARKET CAP. ($MMS)	$46,516	$244,972
2011E EARNINGS YIELD	7.25%	5.80%
2011E EARNINGS GROWTH	7.60%	10.00%
PREMIUM TO NET ASSET VALUE	-1.70%	-7.70%
2011E NET DEBT/ENTERPRISE VALUE	51.30%	40.70%

Source: CIBC WM, UBS, BMO NB

UTILITIES VALUATIONS

	NORTH AMERICA	GLOBAL
2012E DIVIDEND YIELD	4.30%	4.90%
2010-13E EPS GROWTH	0.20%	4.88%
PRICE TO EARNINGS (2012E)	14.5x	13.7x
5 YEAR AVERAGE P/E	15.6x	17.0x
2012E ENTERPRISE VALUE/EBITDA	8.4x	7.8x

Source: UBS

SENTRY REIT FUND SECTOR ALLOCATION

RETAIL	20.88%
MULTI-RESIDENTIAL	19.57%
OFFICE	13.68%
INDUSTRIAL	2.57%
SENIORS' HOUSING	4.09%
LODGING	0.00%
DIVERSIFIED	22.78%
SPECIALTY	8.63%

SENTRY REIT FUND ASSET ALLOCATION

CDN. EQUITY	73.02%
US EQUITY	19.25%
GLOBAL EQUITY	0.00%
N.A. FIXED INCOME	0.00%
GLOBAL FIXED INCOME	0.00%
ETF/DERIVS.	0.00%
CASH	7.73%
ASSETS	$851,208,468

SENTRY INFRASTRUCTURE FUND SECTOR ALLOCATION

INDUSTRIALS	27.15%
PIPELINES	9.08%
UTILITIES	14.66%
ENERGY	14.08%
CONSUMER	3.84%
POWER	8.41%
INFRASTRUCTURE	0.00%
SPECIALTY	8.10%

SENTRY INFRASTRUCTURE FUND ASSET ALLOCATION

CDN. EQUITY	60.06%
US EQUITY	20.22%
GLOBAL EQUITY	5.43%
N.A. FIXED INCOME	0.00%
GLOBAL FIXED INCOME	0.00%
ETF/DERIVS.	0.00%
CASH	14.29%
ASSETS	$44,670,513

Market environment

S&P finally cut the credit rating of the US, mainly due to the political impasse in Washington. The markets responded by selling risky assets and moving into safe havens – mainly US treasuries, which had just been downgraded. Since August 5th - when the downgrade happened - US 10-year bond yields have fallen from 2.5% to 1.9% at the end of September. Even Bill Gross at Pimco was forced to admit that his call on US treasuries was wrong. The Treasury Department and the Fed are working together to bring longer duration rates even lower and Operation Twist was implemented to accomplish just that. As a result, the 30-year mortgage rate in the US is now below 4%. The hope is that the housing market will get a boost as borrowers refinance and/or rollover into lower rates they can afford. There is also talk that the Obama administration is likely to take steps to make mortgage refinancing even more possible through adjustments to the Home Affordability Refinance Program (HARP). While these steps will help at the margin (so far HARP has refinanced one million US mortgages), the larger issue is the sheer amount of debt and the lack of jobs and confidence in the economy.

Inflation is starting to pick up but a lot of this can be traced to seasonality in the housing market. The spring buying season saw a transitory pick-up in sales activity and home prices, as measured by the

S&P/Case-Shiller Index. However, US home prices have resumed their downward trajectory, albeit at a slower rate than last year. Add in the fact that West Texas Intermediate (WTI) has fallen, and gasoline prices at the pump have moderated, and the rising inflation prints are likely to fall back below 3% in the near term. At this rate, the Fed will likely be on hold well past mid-2013.

Jobs remain the elusive Holy Grail for the US economy, and in this regard, little is likely to happen before the 2012 presidential election. President Obama's jobs bill will have trouble in the Democratic-held Senate, and will likely be dead-on-arrival in the Republican-held House of Representatives. The escalation of the juvenile, extremist argument between tax cuts and stimulus spending and the effects of "re-districting" (i.e. almost every Congressional seat is now "safe" so candidates are free to take extremist, House partisan stances in the nomination contest without fear of losing the general election) have combined to eliminate most of the common ground between even moderate Democrats and moderate Republicans. In this environment, we feel that a political "reset" is likely required to make Congress productive again.

The Eurozone is coming closer to its "Lehman" moment, with Greece the most likely candidate to default first. However, Ireland continues to tick-down to judgment day, and various banks are showing up as capital deficient or actually insolvent. Recent rumours have the Germans and French huddling to come up with a credible plan to avert a default of a Eurozone member and the actual dissolution of the Euro itself. However, one must recognize that the problems are too large and complex to be resolved without significant and widespread pain.

Having said all that, the good news is that investor sentiment is so bearish it almost screams market bottom! Speculation is rampant about whether this is "a bottom" or "the bottom". Regardless of what it turns out to be, we feel strongly that five years from now, investors who purchased high-quality, dividend-paying stocks at current valuations will be rewarded for their careful analysis and intestinal fortitude. Over six billion human beings will wake up tomorrow morning and get on with their daily lives and routines. Those businesses that are properly managed and structured, and are an integral part of those daily routines, stand to be the best performers from this point on.

Sentry REIT Fund

Portfolio review

Canadian REITs, as measured by the S&P/TSX Capped REIT Index, delivered a total return of -0.7% from August through September. However, this performance was exceptional compared to US REITs and the broader markets (MSCI REIT Index down 15.9%, S&P/TSX 60 down 9.8%, S&P 500 down 12.1%). Sentry REIT Fund's assets fell to $851 million as our US REIT positions declined. However, net sales were very strong at approximately $29.5 million, as investors purchased the Fund as the NAV declined.

The top performers this month were Chartwell Seniors' Housing REIT, Canadian REIT and RioCan REIT, up 5.9%, 2.5% and 2.3% respectively. Chartwell bottomed out as selling pressure abated after another weak quarter. Chartwell announced the clean up of its ownership stake in a US subsidiary, and concentrated management of its US assets with Brookdale Senior Living. Again, more evidence that management is making progress in turning this business around. Canadian REIT and RioCan REIT are two of the oldest and largest REITs in the country, and both attracted significant flows from generalist and dedicated investors during a period of high market volatility and continued REIT outperformance.

Cash was up 340 bps to 7.7% as we sold every rally after the US debt ceiling was raised. We had actually expected the market to rally strongly after an agreement was reached on August 1st , however, the ISM (Institute for Supply Management) number released that same day spooked investors and caused the market to retreat (on a holiday in Canada no less!). Later that week, the US credit rating was cut leading to further market volatility and losses. Anticipating that other issues would crop up in Europe, we sold rallies and raised cash, getting as high as 9.5%. Some interesting opportunities cropped up in French and Australian REITs, but we chose to eliminate a couple of mid-cap US names and re-allocate the capital into our larger-cap US names that sold off. Subsequently, in the US REIT space, larger caps have significantly outperformed small caps, validating our switch.

Portfolio outlook

The recent pullback has seen Canadian REITs trade down to 14x AFFO and a 3% discount to NAV. US REITs have come all the way back to 16x AFFO and a 5% discount to NAV. Essentially, the market is valuing these companies based on in-place cash flow with no value given for growth potential (hence the discount to NAV). Given the fears of a global slowdown and potential second recession, we understand this. However, this makes less sense for REITs than for traditional operating businesses. If we do go into recession, RIM will undoubtedly sell fewer BlackBerrys and Manulife will see its actuarial liabilities rise at a time when its investment returns fall (both on the back of falling bond yields). Both will likely see earnings declines. However, unless these businesses go bankrupt, REITs will see their rents from these companies increase next year as contractual increases kick in, and rents are renewed at discounts to market but increases to expiring rents. In general, the market is valuing Canadian and US REITs as if their cash flow will decline next year, when in all likelihood it will be flat to slightly higher. High, tax-efficient yields and some material mis-pricing should lead to strong returns from this entry point.

The Federal Reserve Bank has announced it will keep rates low until at least mid-2013 and the Bank of Canada is unlikely to make significant moves during that time period. Corporate reporting will drive some short-term moves in the market with the focus on guidance and outlook. GDP forecasts for the US, Canada, China and the Eurozone have been revised lower several times this year, and it is likely that corporate earnings will follow suit. However, we'd like to point out that rents are an operating expense for traditional businesses. By the time you get to the earnings line, you've already paid them. Fixed-income investors are quick to point out that debt is serviced out of pre-tax cash flow not earnings. Well, rents are also serviced out of pre-tax cash flow, and not earnings. So similarly, investors can think of corporate earnings as their margin of safety when investing in REITs. Declining corporate earnings are never good, but corporate earnings would have to turn into corporate losses and the company would need to declare bankruptcy before contractual REIT rents were impacted. If corporations grow their earnings by 20%, their rent does NOT increase by 20% and similarly, if corporate earnings decline by 20% their rent does NOT decrease by 20%. The rent payable is a contractual agreement enforceable in the court system. Going forward, this type of cash flow resiliency and transparency will likely attract a premium multiple, especially if market volatility remains elevated.

In Canada, our rotation into large-cap names is complete. However, their recent outperformance has made their total return outlooks less attractive than their mid-cap peers who have sold off. Accordingly, we will deploy some of our cash into the mid-cap names, keeping in mind some of them have temporarily evolved into special situations due to short-term restructurings and events. While we are not outright hostile towards small-cap IPOs, the bar has been raised significantly and we don't anticipate participating in many in the near future. Nonetheless, we have now met with 14 different groups that wish to launch IPOs or new products and the potential pipeline continues to swell.

We are comfortable with our US positions and weightings and will wait to see what opportunities earnings season brings. US REITs have historically yielded half as much as Canadian REITs, and their share prices have been materially more volatile, necessitating a more active trading strategy. In an overall market with heightened volatility, we intend to be more active trading these names, while still recognizing the need to collect our quarterly dividends. Our global position remains at zero for now, though recently we were tempted to enter a few European and Australian names. In the end, we decided to wait for greater clarity on the fiscal situation in Europe before making our move. We firmly believe that Greece will eventually default and when that occurs, we want to be ready with dry powder and a hit list of attractive names.

Sentry Infrastructure Fund

Portfolio review

Since July, Canadian utilities, as measured by the S&P/TSX Capped Utilities Index, have gained 3.7% and the UBS Global Infrastructure & Utilities 50-50 Index has gained 0.5% in Canadian dollars. Again, market volatility has driven capital into Canadian utilities, while all of the gain on the UBS index was a function of currency gains as the US dollar returns were 7.6%. Sentry Infrastructure Fund was flat at $42.7 million in assets but has grown to over $44.4 million in assets since the end of September.

Top performers this month were Brookfield Renewable Power, GWR Global Water Resources and Transurban Group, up 10.7%, 10.0% and 4.4% respectively. Brookfield Asset Management announced the merger of its two renewable power subsidiaries (Brookfield Renewable Power Fund which we own, and Brookfield Renewable Power Inc. which is wholly-owned by BAM). The market reacted favourably to the creation of an even larger hydro and wind power generator with exposure to Canada, the US and Brazil. GWR Global Water Resources is a US-regulated water utility IPO from earlier this year. The company has proprietary water management software that improves billing and collection efficiency for municipalities. The stock has been crushed since the IPO, and recently rebounded as selling pressure appears to have abated. Transurban reported soft traffic volumes on its Australian toll roads. However, management remains confident that material dividend growth is sustainable over the next three years.

Our cash position soared 929 bps to 14.3% as we cut our weightings in more economically-sensitive names and sold into rallies. Our Canadian positions were reduced mainly on price declines and some selling in our engineering and construction positions. Our US position has almost tripled on capital appreciation (driven by impending dividend, conversion and spin-out catalysts) and purchases. Our global allocation fell from 20.1% to 5.9% as we exited the UK and Europe ahead of sovereign debt concerns. Subsequently, these were some of the toughest hit areas after the US credit rating downgrade and some interesting opportunities materialized. However, we intend to stay underweight Europe until Greece defaults or restructures. The industrials and utilities weightings both came down as a result of the selling of Canadian and European positions in these sectors. The energy and power weightings have climbed, as our Canadian midstream and power generation names have materially outperformed during this period of heightened market volatility.

Portfolio outlook

The economic sensitivity of the Canadian portfolio has been reduced by allocating capital away from engineering and construction firms (more transactional cash flow) into utilities and midstream companies (fee for service and tolling cash flows). This switch has also resulted in a higher yield from this portion of the portfolio, and absent material economic growth out of the US, this stance will be maintained. We would welcome a pullback to add to our midstream names, but quarterly reporting is likely to reflect strong frac spreads and high-storage volumes, making any pullback relatively shallow and short-lived.

Our US position has broadened out from utilities to include some midstream energy companies and industrials. There are several catalyst stocks in this area (dividend increases, exploration spin-outs, REIT conversion) that should see their catalyst event happen in Q4 or early Q1. We feel there is material upside the market is ignoring in several of these names, and we continue to add to them on weakness. Post these catalyst events, we will continue to hold these companies, however, their weightings may be reduced on lower total return outlooks. The harvested capital will likely be directed to cash or global positions, as we remain materially underweight infrastructure and global positions.

We still hold only two infrastructure names in Australia. Both have recently reported slowing volumes (traffic and passenger) but have reiterated their dividend and earnings guidance. We would like to add to both on weakness, and continue to favour Australia on relatively strong fiscal, financial and monetary outlooks. Germany and the UK are also markets we would like to increase our exposure to, on relatively attractive regulatory and pricing outlooks for power and water. In addition, telecom firms appear to be attractively priced in many Nordic and Asian markets, and we anticipate allocating capital there regardless of market volatility, as cash and dividend yields have blown out and are very attractive.

Thanks and good hunting.