

Equity commentary

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

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Market environment

The S&P/TSX Index (TSX) was down and the S&P 500 Index was up slightly the last two months of 2011, with the major driver being the news flow out of Europe. Everybody was fixated on the European debt crisis and the markets responded accordingly. The questions continually raised were whether Italy was going to be the next one to fall, and whether Greece was going to come out of the crisis intact. Another factor was China slowing down. All of these fears were coming to a head as 2011 came to an end.

In terms of news flow, an interesting recent statistic from Merrill Lynch about the S&P looked at the correlation of daily moves greater than 1% and news headlines over a number of years. If you go back to pre-crisis times, it appears that news out of the US moved the market by more than 1% on any particular day. News coming from other countries did not seem to have the same impact. As we fast forward to 2011, almost 80% of market moves greater than 1% – especially in the last half of the year – were affected by bad news coming out of Europe.

Market outlook

We are cautious about the market going forward. The US economy looks like its stabilizing and actually improving slightly. Even so, we believe that volatility as a theme will continue, and that markets will move a fair bit – probably around 10%. Whether that 10% is up or down depends on extraneous factors – mainly Europe. Is Greece going to leave the Eurozone group of countries? Will Italy be able to avoid defaulting? What is going to happen to Spain? Will Germany's economy enter a recession because it gets completely dragged down by the rest of the Eurozone? If China slows down, will commodities be impacted negatively? All of these are potential situations that we are constantly monitoring.

Another factor is that stock correlations are currently running very high. Correlation is a measure of the tendency of securities to move in the same direction at the same time – the higher the number the more likely all securities are going up at the same time. The index that tracks correlations in the S&P 500 is around 80% – the normal range being around 60%.

Portfolio update

Since the end of August 2011, when the portfolio management for Sentry Diversified Total Return Fund changed, the Fund has outperformed the TSX by about 225 basis points. Furthermore, the Fund performed in a much smoother fashion as opposed to the TSX,

which had a lot more ups and downs. Since the end of October, the Fund is down 50 basis points and the TSX is down almost 300. The Fund's outperformance was mostly due to cautiousness on our part. Performance could have been better perhaps, but we decided to sell a large bond holding at a steep discount because we believed it was in the best interest of unitholders. Still, the Fund outperformed the market by roughly 250 basis points over the last two months of the year.

We increased the Fund's holdings in the technology sector, beginning in the hardware space, and especially in semiconductors. We currently own three semiconductor companies that are cash rich and have no debt. We also made a move into some software names that look reasonably valued and in areas that are critical to enterprises like security and mobility. The technology sector is diverse in the US and there are many good companies that generate lots of free cash flow and have the potential to pay dividends. It's a very cash-rich centre right now.

Sentry Market Neutral L.P. didn't fare as well because of large redemptions. As a result, positions became exaggerated in terms of size. We were still in the process of exiting out of positions that we no longer wanted to be in since the previous portfolio manager's departure, and some of those moves hurt Sentry Market Neutral L.P. That was in addition to all the volatility in the market and stock correlations being so high. We had short positions in companies we thought were in distress or had bad balance sheets; some of these rose by as much as 20%, even with the market rallying around 7% the last few days of November, largely because of a big beta chase by investors. Our longs increased only around 5% to 7% during the same time period.

Portfolio outlook

If the US economy continues to improve and Europe stabilizes, we will put more cash to work and put fewer short positions on. If we don't see improvement in Europe, we will keep a very cautious outlook and will maintain a healthy balance sheet. We will use options to augment the income stream. That means selling covered calls or selling deep out-of-the-money puts for companies that we don't mind owning at a certain price. We'll also look at parking cash into much more liquid, bond-like securities to gain a healthier income stream – perhaps 2% to 4%. But they must be liquid enough to allow us to deploy cash and buy more stocks if the macro environment appears to be getting healthier.

We continue to like technology because it's a beaten-down sector and because we see opportunities in certain pockets. The other area we see as positive going forward is energy services. In the last few months of 2011, this area has really been beaten down. Our goal is to gravitate more to the US in terms of that sector, because there are much larger energy service companies that pay dividends there. There are some in Canada that pay dividends, but they are, on scale, a lot smaller.

The final area we've been sifting through is financials. Banks in the US and Europe have been basically decimated, so we may cautiously tiptoe into some of them. We'll also look at US regional banks, where there's no real exposure to what happens in Europe. It's all about monitoring what's taking place globally. But this is one sector that people are generally overlooking, so we think there are definitely opportunities there.

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.

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