

Quarterly Commentary—March 2011

"If you see the bandwagon, you've missed it"

James Phillips

First Quarter 2011: Decision Making and Uncertainty

Geopolitical events dominated stock, bond, and currency trading during the first quarter of 2011 ending March 31.

In the Middle-East, Tunisian and Egyptian citizens decided they were fed up with years of corruption and a lack of basic freedoms, and peacefully ushered their Presidents into retirement. In Libya, the protestors were not as lucky, as the Libyan ruling clique used their armed forces against their citizens in a desperate attempt to hold onto power. At this point, it looks as though a stalemate is likely to prevail with Libya divided both geographically and by tribal loyalties.

In the Gulf region, Bahrain, protestors have called for the abolishment of royal rule, and the citizens of other countries in the gulf region of the Middle-East cannot be far behind including those of Saudi Arabia. All of this adds up to a great deal of uncertainty with respect to the stability of oil supplies from this crucial region, and will likely lead to elevated oil prices for some time to come. To the extent that higher prices encourage conservation and the substitution of alternative energy and natural gas for oil, the world will be better off for it.

The political changes sweeping the Middle-East were soon dwarfed by the multiple disasters that struck Northern Japan in the middle of March. The massive earthquake and the ensuing tsunami that flooded vast areas of Northern Japan have caused great human tragedy, and hundreds of billions of dollars in damage to the area. While widespread radiation damage was averted despite the failure of several nuclear reactors, the global nuclear industry has no doubt been set back for years. Meanwhile the Japanese economy is likely to briefly experience a recession, before beginning to grow again during the summer as massive rebuilding efforts get underway. For investors, the big question and uncertainty is what will happen to global growth as a result of higher oil prices, and the negative shock from a likely Japanese recession?

With respect to Canada and the U.S., exports to Japan are quite minimal, which suggests there should be little or no negative impact from Japan. However, high oil prices tend to be supportive of both the Canadian dollar and our overall economy, while the same is not true for the United States. In the past, higher oil prices have had a more substantial negative impact on U.S. growth relative to Canada, and this is one of the reasons for the continuing strengthening of our dollar.

In Europe, the bigger issues still revolve around the so-called periphery economies of Greece, Portugal and Ireland, and their ability to manage their debt and access the capital markets to fund their deficits. On that front, the news has been somewhat encouraging with Germany winning key financial concessions from Portugal and Greece in exchange for European Union (EU) support to reduce the cost of their debt, and to help finance their current account deficits.

All-in-all, the recent geopolitical events are likely to cause a slight reduction in global growth while ensuring that short-term interest rates around the world will remain at extremely low levels for at least the near term.



Canada

- Canadian dollar breaks through 1.04 driven by high oil prices and an improving fiscal position
- Will May 2nd Election finally break the minority gridlock?

United States

- U.S. economy continues to add jobs as expansion continues. Unemployment falls to 8.7%
- U.S. productivity rising at rapid rate helping to keep wages and inflation in check

Europe

- Eastern European economies continue to boom driven by capital investments from Germany, relatively low wages, currencies, and a skilled workforce
- Russian President Dmitry Medvedev orders the removal of all politicians from corporate boards in a bid to lessen corruption and improve transparency for investors

China

- Chinese economy in danger of overheating as monetary base expands rapidly and wages continue to rise
- Interest rates and bank reserves are moving higher as Chinese government tries to slow their economy

Japan

- Japan contemplating nationalization of TEPCO (nuclear utility) and puts future nuclear power- plant construction on hold



Economic Outlook 2011-2012:

Main Street Recovering - Our leading economic indicators (see **Chart 1**) declined modestly during the first quarter of 2011, suggesting that global growth is likely to slow in the fourth quarter and into 2012.

Nonetheless, there continues to be a healthy improvement in hiring and job growth in the U.S., and we expect that the current economic recovery will continue into 2012, albeit at a slightly lower growth rate than in 2011.

The Trillion Dollar Elephant in the Room - Of greater longer-term concern to the capital markets both for bonds and for stocks, is the huge U.S. fiscal deficit, which at \$1.3 trillion per year, represents about 10% of the Gross Domestic Product (GDP) of the United

States. The U.S. federal debt is about 70% of GDP, which is still below the levels of most developed countries, but this total excludes looming deficits in the U.S. Social Security and Medicaid programs as baby boomers begin to retire.

There is no question that the long-term viability of the U.S. economy (and of their currency) is dependent on the ability of their politicians to tackle difficult and politically-charged issues with respect to government spending, entitlement programs and taxation. Unfortunately, there is little reason to be optimistic on this front. The Republican Party is adamant there will be no new taxes, and in fact, Republicans wish to reduce corporate tax levels from 35% to 25%. The Democrats are equally adamant that taxes for high wage earners must increase, and that corporations must also share the burden.

With respect to Social Security, there may be room for compromise with the Republicans, led by the Chairman of the House Budget Committee, Paul Ryan, offering to grandfather those 55 and over, while reducing government retirement promises to those under 55. Retirement age for public employees are also likely to rise in the not-to-distant future. While these policies will help to put the U.S. Social Security program on a sustainable path, the vast philosophical differences between the two parties in terms of the role of government, and how to fund that role, will still make it very difficult to significantly reduce Federal government deficits. Under these circumstances, the most likely path is a gradual slowing in government spending alongside entitlement reform, and a slow reduction in the deficit as a percentage of GDP. In our view, these modest improvements are unlikely to reverse the long-term secular decline of the U.S. dollar.

The Game Plan - Modest economic growth, low (but rising) inflation, and high debt levels suggest that the economy, and public stock markets, will remain vulnerable to shocks such as this quarter's economic fears over Japan and the Middle-East and last summer's fears about Europe. It would be sensible to assume that the markets will remain more volatile than the underlying economy, thus creating trading opportunities from time-to-time. For the next few years, stock and bond market returns are likely to remain at, or below, their long-term averages, meaning that high-yield stocks and alternative investments should play a larger role in your portfolios. These types of investments will reduce the volatility of your assets, help to preserve capital when public markets are under pressure, and generate steady income for reinvestment or retirement needs.

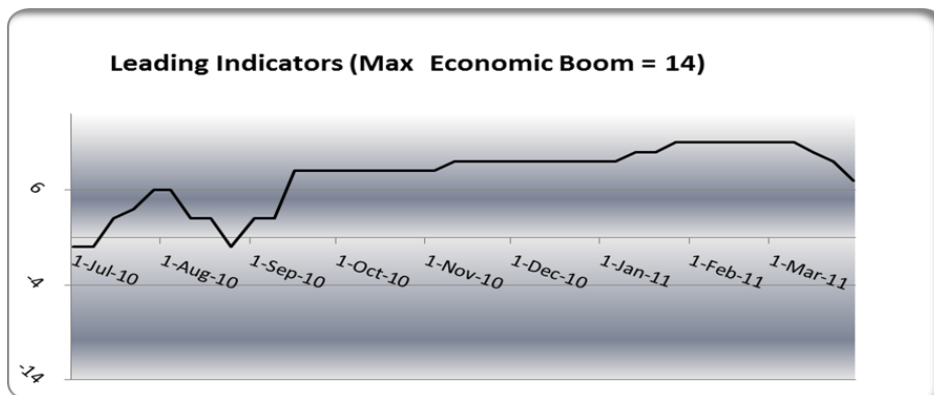
Capital Markets Outlook:

Bond Markets – Government bond yields in Canada and the U.S. remained range bound through most of the first quarter, with the U.S. 10-year treasury finishing the quarter with a yield-to-maturity of 3.46% (see **Chart 2** on page 3). Shorter-term interest rates in Canada and the U.S. are still below 1.0%, and these rates are likely to begin rising in the second half of 2011 as policy makers begin the process of normalizing interest rates. Inflation expectations, while rising in Canada and the U.S., are still relatively modest with the bond market signaling 2.0%-2.50% inflation as the most likely course going forward.

In this environment we see little upside to owning government bonds as the risks outweigh the potential returns by a considerable margin. Investment-grade corporate bonds, high-yield "blue chip" stocks, and rent producing real estate all offer superior risk/return tradeoffs versus passively investing in sovereign debt.

North American Equity – The rally in North American stocks that occurred throughout 2010 has pushed equity markets to

Chart 1: Global Economic Leading Indicators



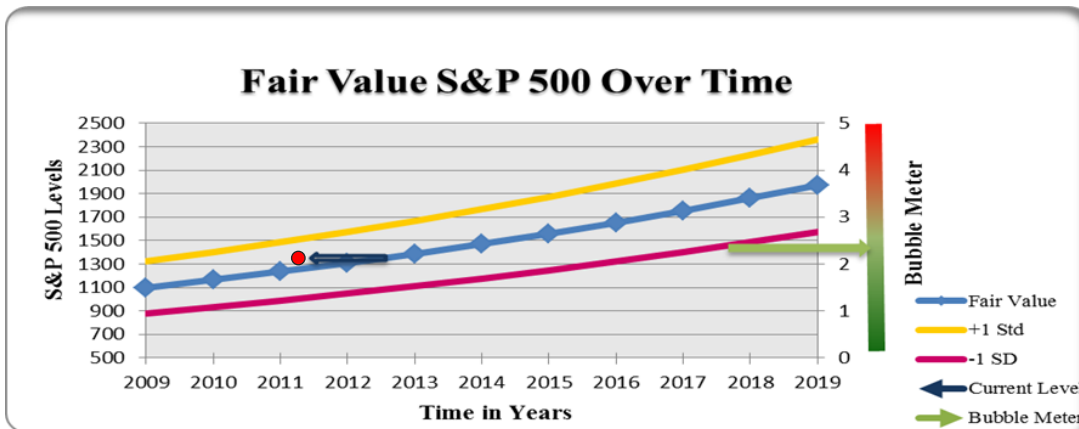
near fair value suggesting that returns in the 5%-6% per annum range over the next few years are the most likely outcome. **Chart 3** below highlights the most likely paths for the stock markets going forward. The blue “Fair Value” line shows our current and future estimates for the fair value of the S&P 500 equity index in the U.S. On the right axis we have superimposed our “Bubble Meter” readings which are used as a gauge to help determine the level of speculation in the stock markets. All else being equal, low speculation means less downside risk for investors and vice versa. Today, the “Bubble Meter” is in a neutral position, meaning that there is no excess exuberance (or pessimism) in the stock markets.

Chart 2: US 10-Year Bond Yield—Six Months Ending March 31, 2011



With respect to valuation, the U.S. stock market, as of March 31, 2010, was slightly above its fair value (red dot on Chart 3) using what we believe to be conservative inputs into our model. At today’s level, the S&P 500 is discounting future

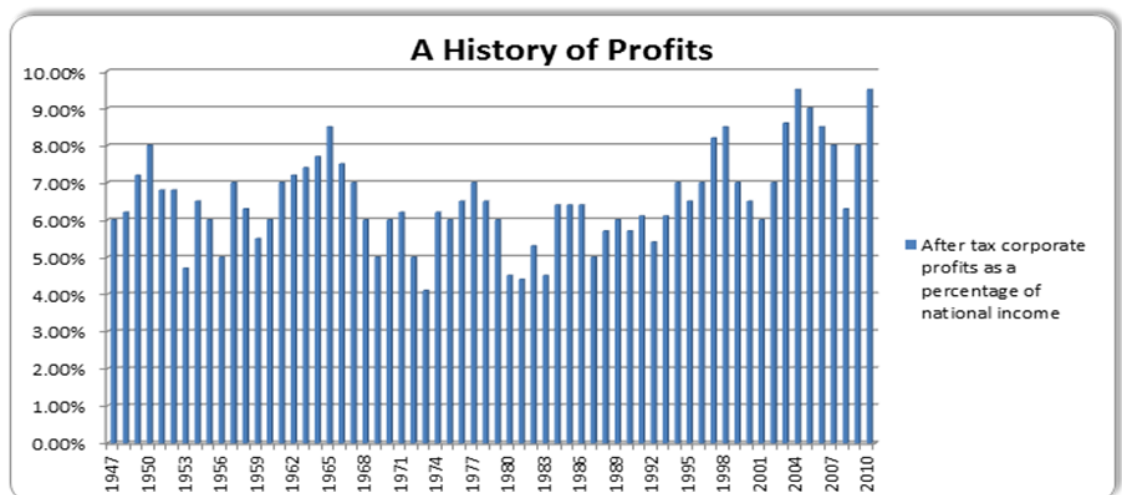
Chart 3: S&P 500 Fair Value Over Time



(nominal) growth rates for dividends of 5.8% per annum, which appears about right to us given today’s low dividend payout ratios, high corporate cash levels and continuing economic growth. With reinvestment opportunities at relatively low levels, corporations will continue to increase their dividend payouts and stock buybacks, which should help to move the markets higher over time.

Earnings’ Growth Set to Slow - Although earnings and dividends are supportive of current stock prices, we are concerned that earnings’ growth rates are bound to slow from what has been seen in the past two years. One problem can be seen in the “A History of Profits” chart. As shown, corporate profits as a percentage of the U.S. economy are now back to historical highs. This means that earnings’ growth going forward will be more a function of sales growth and stock buybacks than from a continuation in operating margin improvement. On that front, the gradual slowing in the global economy that we are forecasting may constrain sales growth, causing earnings to disappoint in 2011 and 2012. In this environment, stock selection is more important than ever with respect to your equity holdings, as it is likely that well-positioned and well-managed growth companies will outperform those companies that are more dependent on general economic growth to prosper.

Chart 4: A History of Profits



Bullion and Precious Metals - Prices for gold and silver continued to climb during the first quarter of 2011, with gold trading as high as \$1,450 per ounce. There are many factors driving this trend, the most important of which appears to be the ultra-low interest rates that currently prevail in most of the world's developed economies and political and economic instability in the Middle-East and in Japan. With short-term interest rates well below current inflation rates, so-called "real" (after inflation) interest rates are now negative. This same phenomenon occurred throughout most of the 1970's which, not coincidentally, was the last great period of gold outperformance. Negative real interest rates discourage savers from investing in short-term paper, and in this environment some of the normal demand for money market and savings accounts finds its way to gold. Gold is now viewed as a substitute for paper currencies, especially when investors are not being properly compensated for investing in U.S. dollars. In addition to low interest rates, there are several additional factors driving gold higher including a perception that the global banking system is still at risk, fears of large sovereign debt levels, investor demand for alternative assets, high gold mining costs and a lack of new mine supply.

MacNicol & Associates Alternative Asset Strategy Update:

MacNicol Alternative Asset Trust– We continue to invest the Alternative Asset Trust into a mixture of North American real estate (the 360 Degree Fund), hedge funds (the Absolute Return Fund), and private equity (the Emergence Fund). **Chart 5** highlights the asset mix of the Trust as of March 31, 2011. Moving forward, we will be slowly increasing the exposure of the Trust to its hedge fund component with a view to becoming fully invested by the end of the second quarter of 2011.

MacNicol 360 Degree Realty Income Fund - The 360 Degree Fund is currently invested in several value-added strategies and managers. **Chart 6** highlights the current mix of properties in the 360 Degree Real Estate Fund as of quarter end, March 31, 2011. We continue to deploy cash into additional opportunities in residential real estate including multi-family apartments, condominiums, zoned residential land, and single-family homes, while avoiding commercial real estate in the U.S. In Canada, we are slowly increasing exposure to commercial real estate primarily through an investment in the KingSett Canadian Real Estate Income Fund run by Jon Love, formerly of Oxford Properties. During the quarter, we made two new investments in garden-style apartment complexes in Jacksonville and in West Palm Beach, Florida. Both of these projects are well located, and have been purchased from distressed sellers for roughly 40% of replacement cost.

MacNicol Absolute Return Fund - The investment objective of the Absolute Return Fund is to generate positive absolute returns under most market and economic conditions, and to have little or no correlation to the U.S. and Canadian stock markets. In order to achieve its objectives, the Absolute Return Fund invests in several value-added strategies managed by experienced and successful Canadian, U.S. and U.K. hedge fund managers. Most of these investments are not available in the

Chart 5: Alternative Trust Investment Profile

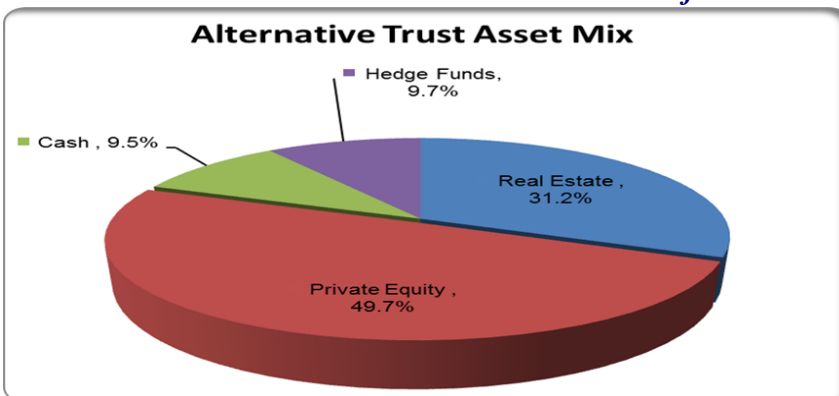


Chart 6: Property Type Allocation

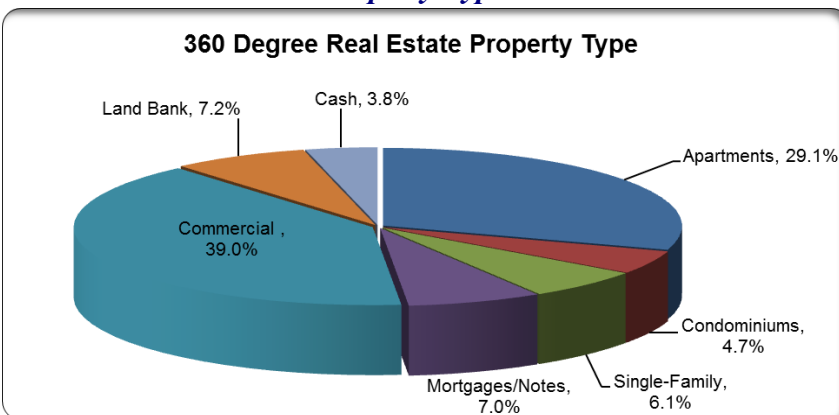
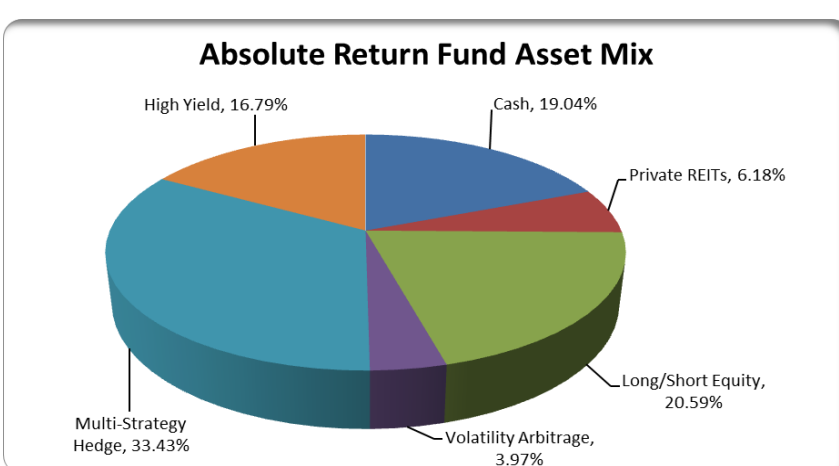


Chart 7: Absolute Return Asset Mix



public market, and are typically not accessible to individuals and smaller institutions because of high minimum investment thresholds, often in excess of \$5,000,000.

During the quarter, we made an initial investment in a high-yield debt fund managed by Contrarian Capital of Greenwich Connecticut. This fund is focused on emerging market debt opportunities primarily in South America and Eastern Europe. **Chart 7** (on the previous page) summarizes the asset mix of the Absolute Return Fund as of March 31, 2010. We will be adding to our allocations of the Multi-Strategy and High-Yield spaces during the second quarter of 2011.

MacNicol Emergence Fund - The investment objective of the Emergence Fund is to generate capital gains by investing in a portfolio of privately held companies and private equity funds. The Fund seeks opportunities where capital exit strategies are clearly defined, and are likely to occur within a three-year time frame. The Emergence Fund invests in established private equity funds as well as direct investments in private companies with defensible franchises, high growth profiles and proven management. Investments will largely focus on profitable companies with high levels of proprietary technology addressing large target markets.

The Fund looks for management teams with proven track records in building and monetizing private companies, and who are accessible and fully-transparent in reporting and communicating with their investors. During the first quarter ending March 31, 2011, no additional investments were made in the Emergence Fund. While it is difficult to accurately predict the timing of liquidity events, we believe that Union Agriculture of Uruguay is likely to list this year on the New York Stock Exchange, while Clear Energy of Phoenix, Arizona is currently in the midst of a significant “up round” of common shares with a large Middle-Eastern sovereign fund. The proceeds of this new round of equity will be used to accelerate the build out of its manufacturing capacity for its breakthrough 1 MW (megawatt), natural-gas fuelled mobile power units (Genesis 1000).

Corporate Developments:

MacNicol & Associates will be hosting our first **client event** of the year on **Wednesday May 18th at the Rosedale Golf Club**. Along with our Portfolio Managers analysis of the current markets and the outlook for the remainder of the year, we are fortunate to have Justin LaFayette and John Berton from Georgian Partners joining us to share their views on the Private Equity markets.

Georgian Partners is a growth equity firm investing in expansion and later-stage enterprise software and information aggregation companies. Founded by successful entrepreneurs and technology executives, Georgian Partners leverages global software expertise to directly impact the success of companies.

Georgian Partners is currently engaged to manage a portion of the MacNicol Emergence Fund, specializing in the technology space.

As with most businesses, a growing client base at our firm is largely the result of client referrals and word of mouth. In an effort to continue growing our firm and its client base, we invite you to join us on the 18th of May and bring along a friend or two. For every friend that you bring along, we will enter your name in a draw to win an Apple iPad which will be awarded at the end of the presentation.

We hope you are able to join us and look forward to seeing you there.

Save the Date: MacNicol & Associates Asset Management’s
10th Anniversary
September 22, 2011. More Details to follow...

MacNicol & Associates Asset Management Inc.

March 31, 2011

An invitation to you and a friend



MacNicol & Associates
Asset Management Inc.

Presents

An Insiders' Look at Private Equity & Public Markets

Date: Wednesday, May 18th

Location: Rosedale Golf Club

Time: 1:00 PM to 2:30 PM
or 5:30 to 7:00 PM

Speakers:

Justin LaFayette & John Berton
Georgian Partners

David MacNicol, President
David Cockfield, SVP & Portfolio Manager
Arthur Salzer, SVP & Portfolio Manager
MacNicol & Associates

Refreshments and Appetizers to Follow

Please R.S.V.P. to Naima Egal
to reserve your space at ext. 226,
or email naima.egal@macnicolasasset.com

Bring along a friend
and receive a chance to win
an Apple iPad!!

100 Adelaide Street West
Suite 200
Toronto, Ontario
M5H 1S3
Tel.: 416-367-3040
Toll: 1-866-367-3040
www.macnicolasasset.com

