



Quarterly Commentary—December 2010

"If all the economists were laid end to end, they'd never reach a conclusion"

George Bernard Shaw

Fourth Quarter 2010: The U.S. Goes "All In"

Global stock markets for the fourth quarter, ending December 31, 2010, rose strongly, capping off a second year of double-digit stock market gains. While impressive for sure, these gains were not without their share of volatility and investor angst.

The year started well enough as the global economic recovery gained further momentum, particularly in the emerging economies. However, by the second quarter of 2010, concerns over the financial health of Greece, Ireland, Portugal and Spain began to spill over into the financial markets. During the summer, tensions rose between investors and the European Central Bank (ECB) as to how to contain the possibility of a debt default in Greece, leading to the potential breakup of the European currency union. Stocks, in turn, sold off for much of the spring and summer as investors assumed the worst.

After much debate, the European Union settled on a combination of emergency loans and central bank buying of distressed sovereign debt in order to calm the financial markets and stabilize the European currency. The beneficiaries of these loans, namely Greece and Ireland, were in turn forced to rein in spending, and increase taxes in order to reduce their budget deficits. While not immediate, these actions, succeeded in restoring calm, and global stock markets resumed their upward march. By September it became apparent that economic growth in the key U.S., European, and Chinese economies was stabilizing after a summer slowdown and investor fears of a "double dip" recession were put on hold.

Entering the fourth quarter of the year, the United States decided to go "all in" in an attempt to stimulate their economy even further, and drive down high U.S. unemployment rates, still near 10%. The first major move was to increase government bond purchases by the U.S. Federal Reserve (so called quantitative easing). The immediate impact of this move was to depreciate the U.S. dollar further, and commodities from gold to oil rocketed higher on the news of continuing cheap money and a lower U.S. dollar.

During November, the Democrats lost control of the Senate and President Barack Obama was forced to abandon his plans to increase taxes in 2011 and begin the long process of restoring the U.S. balance sheet to sustainable levels. The combination of quantitative easing and lower taxes boosted confidence in future corporate profit growth, but discouraged fixed-income investors who had hoped to see some fiscal restraint on the part of the U.S. government.

The effect of these policy changes was dramatic. Global stock and commodity markets rallied by almost 10% in the fourth quarter, while bond markets around the world had their worst quarter with average declines of about 6.0%.

It remains to be seen if the actions by the U.S. government will reignite inflation down the road. Certainly every attempt is being made to stimulate consumer demand through lower taxes, quantitative easing and government spending on infrastructure projects. However consumers are still retrenching from high debt levels, and are saving more to fund their retirement plans. Under these circumstances, it is difficult to imagine consumer demand in Canada and the U.S. accelerating dramatically, and therefore pressure on the prices for goods and services are likely to remain relatively constrained in the near term.

Canada

- Bank of Canada (BOC) head Mark Carney warns of high Canadian debt levels and possible rising interest rates
- BOC remains optimistic about Canadian business conditions

United States

- U.S. job growth accelerating as economic expansion broadens
- President Barack Obama agrees to extend Bush era tax cuts for the wealthy for an additional two years

China

- Inflation rate accelerates to 5.0% led by higher food costs, higher rents and increasing wages, interest rates rising
- Chinese minimum wage rate in Beijing increased by 20%
- Chinese policy makers suggest Renminbi to rise by 7% annually against the U.S. dollar for next 10 years as China shifts away from export-led economy

Emerging Markets

- Brazilian trade minister warns of potential for global currency trade war if U.S. continues debasing its dollar



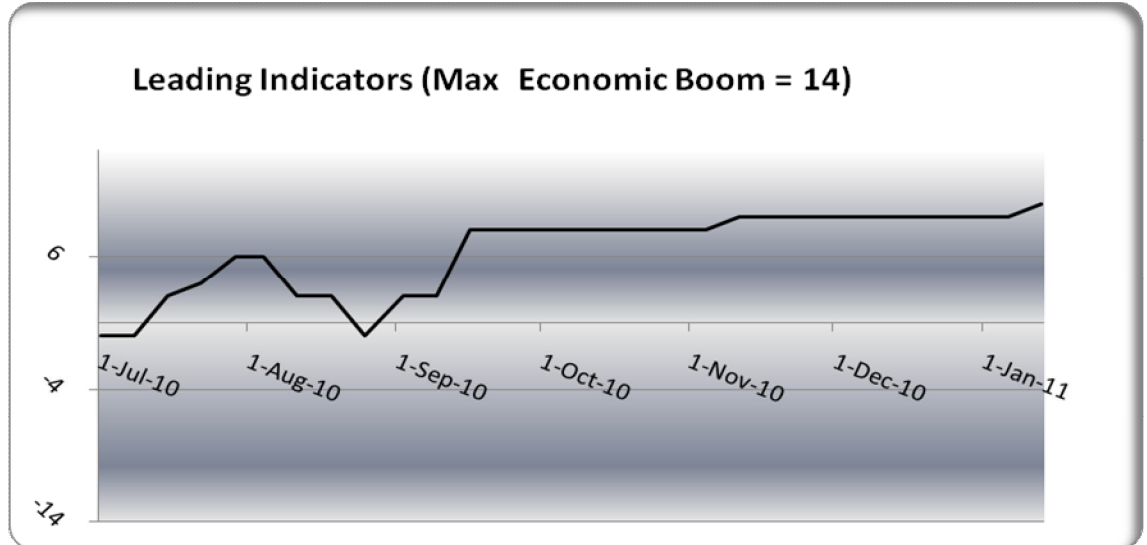
Economic Outlook 2011-2012:

The Year of the Main Street - Our leading economic indicators, after see-sawing around for several months, turned substantially higher in the fourth quarter suggesting further improvements in the global economy for 2011. Driving the improvements in our indicators have been a decline in initial unemployment claims in the U.S., an increase in monetary growth (suggesting banks are beginning to lend again), strength in commodities, tightening of credit spreads, and improving breadth in the stock markets (see **Chart 1**). While we do not expect the U.S. economy to enter into boom territory anytime soon, the data suggests the global economic recovery that began in June of 2009 is likely to continue throughout 2011. In the U.S., consumer savings rates will remain at high levels, but the end of the mass layoffs of 2008 and early 2009 will nonetheless encourage modest increases in consumer spending going forward.

The Game Plan - Modest economic growth, low inflation and high debt levels suggest that the economy, and public stock markets, will remain vulnerable to shocks such as the recent economic fears that rattled the stock markets last

summer. 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 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.

Chart 1: Global Economic Leading Indicators Remain Strong



Capital Markets Outlook:

Bond Markets – Government bond markets in Canada and the U.S. performed very poorly during the fourth quarter of 2010 as debt holders were disappointed by the large U.S. tax cuts, and continuing massive U.S budget deficits. The 10-year U.S. treasury yields (see **Chart 2**) rose by almost 100 basis points (bps), during the fourth quarter leading to a decline in the price of 10-year bonds of almost 6% during the fourth quarter.

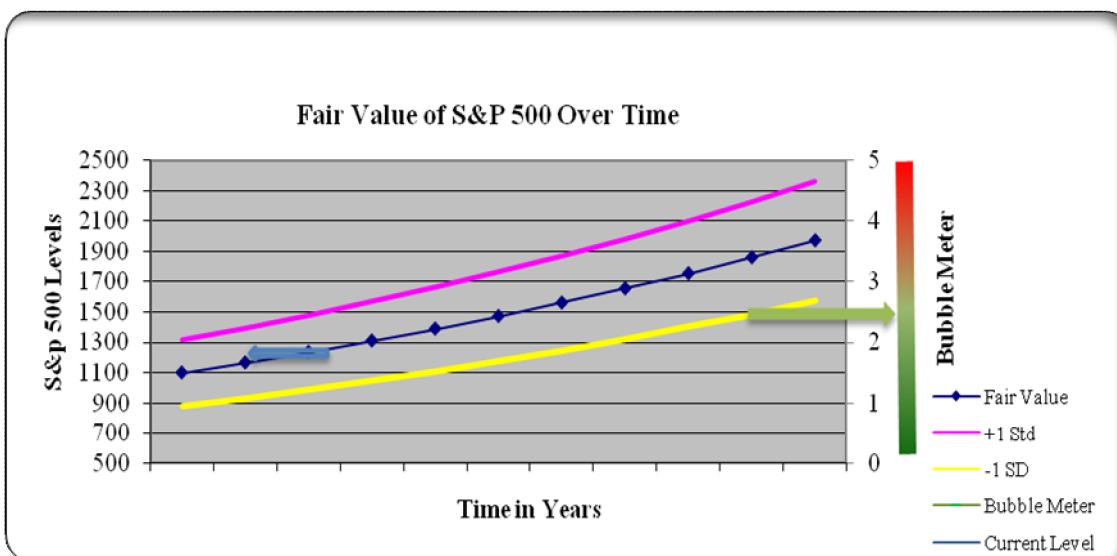
Chart 2: US 10-Year Bond Yield – Fourth Quarter, 2010



We view this shift from government bonds to stocks as the beginning of a long-term upward move in equities relative to government bonds. With respect to generating income within client portfolios, we continue to focus on corporate preferred shares, high-yield equities, and corporate debt. In many cases, yields are 2%-3% higher in these instruments than are available in the Canadian and U.S. government bond markets.

North American Equity – The rally in North American stocks that occurred throughout 2010 has pushed equity markets to 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** highlights the current opportunity we see in the stock market today. 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. The U.S. stock market, as of December 31, 2010, was at its fair value using what we believe to be conservative inputs into our model. At today’s level the S&P 500 is discounting future growth rates for dividends of 5.4% per annum, which appears about

Chart 3: S&P 500 Fair Value over Time



right to us given the already low dividend payout ratios and high corporate cash levels. 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.

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Bullion and Precious Metals - Prices for gold and silver continued to climb during the fourth quarter of 2010, with gold trading above \$1,400 per ounce, near an all-time high for the metal. 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. 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.

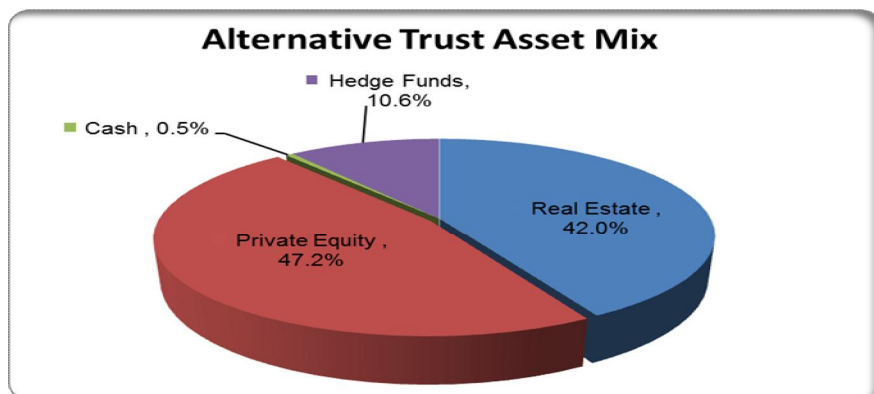
Gold is now viewed as a substitute for paper currencies, especially when investors are not being properly compensated for investing in U.S. dollars. In addition to low interest rates, there are several additional factors driving gold higher including a perception that the global banking system is still at risk, fears of large sovereign debt levels, investor demand for alternative assets, high gold mining costs and a lack of new mine supply.

So while the long-term fundamentals for gold still remain in place, we are carefully monitoring the state of the U.S. economy and of the U.S. dollar for hints of a short-intermediate peak in the price of gold.

MacNicol & Associates Alternative Asset Strategy Update:

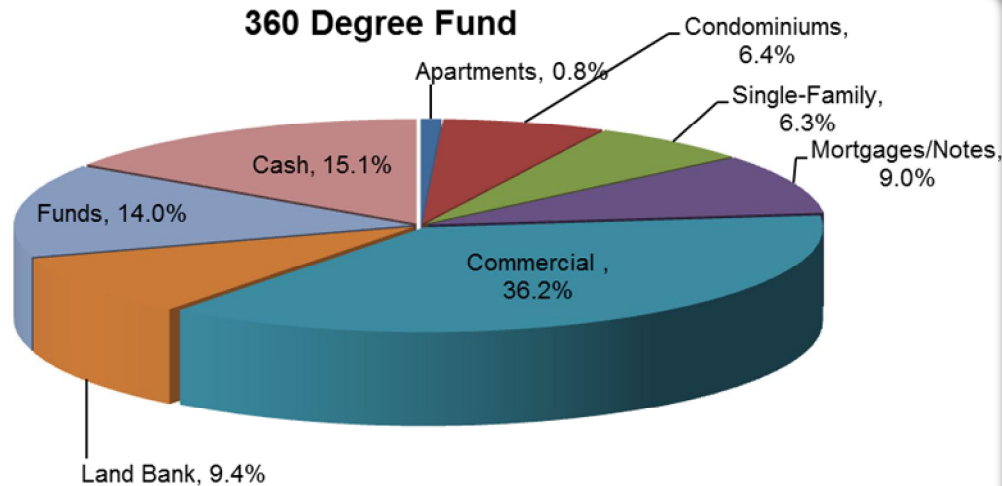
MacNicol Alternative Asset Trust– We continue to invest the Alternative Asset Trust into a mixture of private real estate (the 360 Degree Fund), hedge funds (the Absolute Return Fund), and private equity (the Emergence Fund). **Chart 4** highlights the asset mix of the Trust as of December 31, 2010. 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.

Chart 4 – Alternative Asset Trust Investment Profile



MacNicol 360 Degree Realty Income Fund - The 360 Degree Fund is currently invested in several value-added strategies and managers. These strategies include the purchase and modification of non-performing first mortgages; deed-in-lieu strategies to gain clean title for eventual resale; lease-to-own and credit enhancement strategies designed to maximize the value of purchased homes in foreclosure, and investments in Senior RMBS (residential mortgage backed securities) pools originated in the 2002-2007 periods. These strategies all have one common denominator; the underlying properties are purchased at extremely attractive prices from forced sellers including Fannie and Freddie Mac, GMAC, community banks, hedge funds, insurance companies, and large U.S. money-center banks. **Chart**

Chart 5 - Real Estate Investment Profile by Property Type

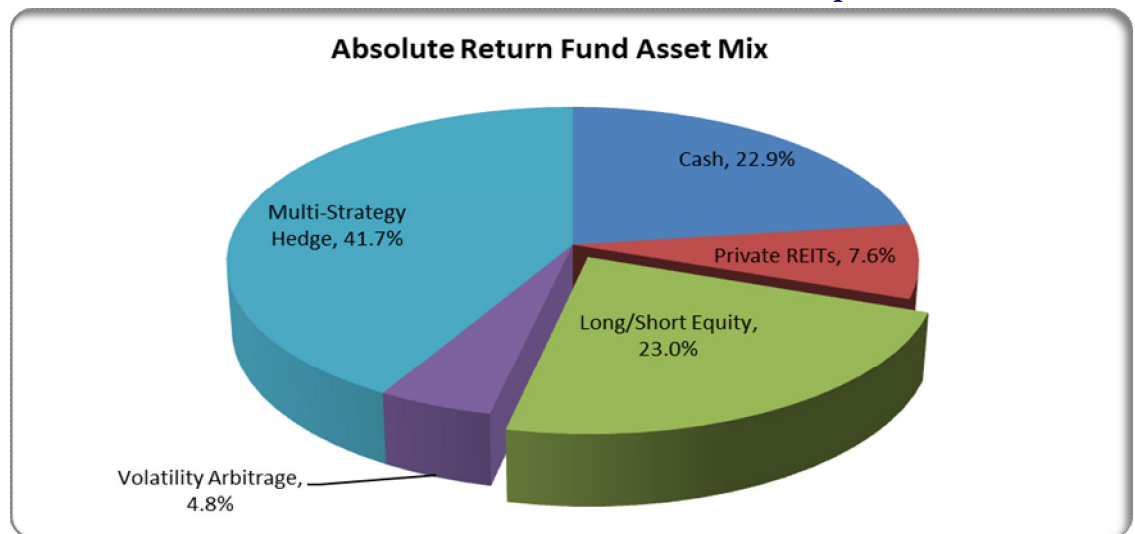


5 highlights the current mix of properties in the 360 Degree Real Estate Fund as of quarter end, December 31, 2010. We continue to deploy cash into additional opportunities in residential real estate including multi-family apartments, condominiums, zoned residential land, and single-family homes, while 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.

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 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.

We are pleased to report that during 2010, two of our underlying Canadian hedge fund managers were ranked first and second in the multi-strategy hedge fund category by Morningstar Canada. In addition to investing in third-party managed hedge funds, the Absolute Return Fund may also take positions in securities or funds representing high-yield credit opportunities primarily in the corporate market. The majority of such investments will be in investment grade debt, preferred shares, and convertible bonds. **Chart 6** summarizes the asset mix of the Absolute Return Fund as of December 31, 2010.

Chart: 6 Absolute Return Fund Position Report



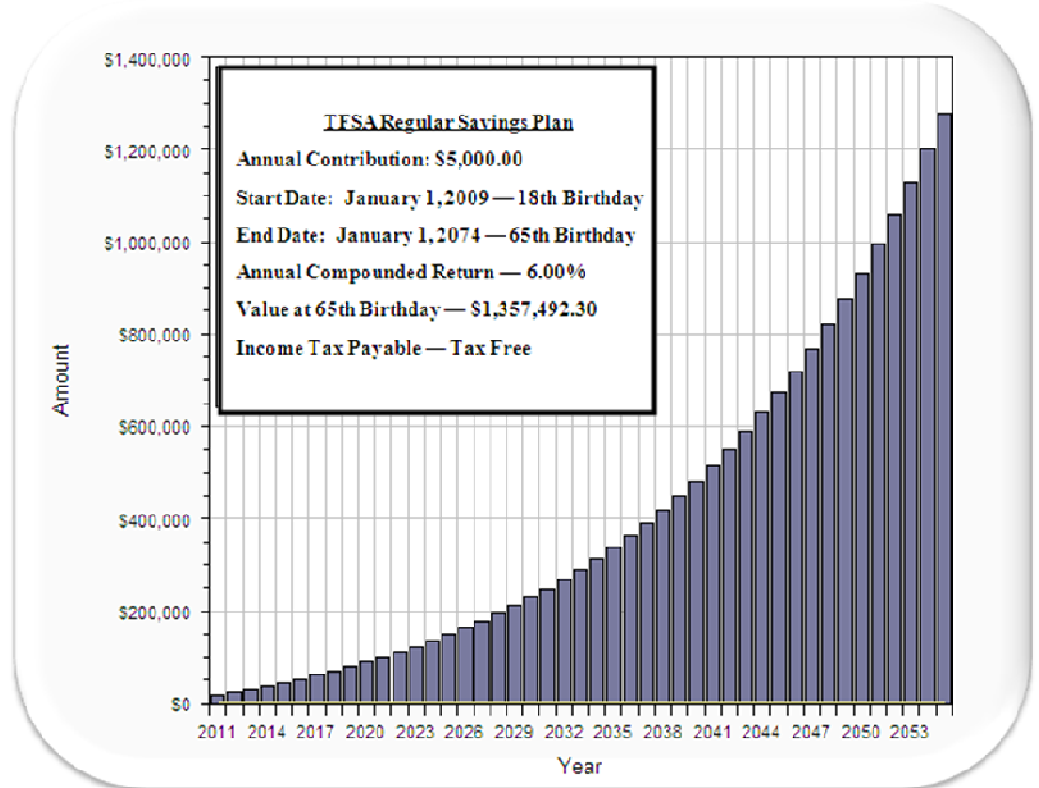
MacNicol Emergence Fund - The investment objective of the Emergence Fund is to generate capital gains by investing in a portfolio of privately held companies and private equity funds. The Fund seeks opportunities where capital exit strategies are clearly defined, and are likely to occur within a three-year 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 transparent to its investors.

Corporate Developments:

It is the season for TFSA's (Tax Free Savings Accounts) - TFSA's are entering their third year in existence, and with the additional \$5,000 of contribution room created this year, the importance of creating or maintaining a TFSA becomes all that more important. We believe that a prudent and low-risk approach to managing your TFSA's is a valuable tool in helping you reach your financial goals. Contribution room is never lost, and a \$15,000 deposit can be made this year. **Chart 7** shows the power of regular contributions to your TFSA. This is a simple strategy that we can put in place for all of our clients. If you do not yet have a TFSA, please feel free to contact us and we would be happy to get you going.

Chart: 7 Growth of a TFSA



MacNicol & Associates Asset Management Inc.

December 31, 2010

