Equity Momentum Locked in a Holding Pattern Over the Second Quarter

Despite a modestly positive earnings season that started in the second quarter, the major equity indices were all down significantly during the opening month of the quarter. The markets then came to life for the balance of the quarter, but without enough strength to generate a positive return. With the S&P / TSX index down –0.02% we continue to experience a market that lacks any defining trends.

At Brownstone, our equity returns essentially reflected general market returns with a total return in our model Canadian Equity portfolio of –0.4% for the quarter. While our energy and material stocks performed well, our significant small and mid cap exposure reduced returns in line with a soft market for smaller cap companies. Energy stocks in general outperformed in the second quarter, with the S&P / TSX Energy index rising 2.3%. Fueled by strong performances by both Talisman and Canadian Natural Resources, our energy stocks returned 5.6% for the quarter. These stocks have continued to perform well into the third quarter. Several of our materials stocks also performed particularly well. These include Dofasco, Cameco and Canfor. Improving commodity price outlooks helped each of these stocks.

In general, small cap stocks had a weak quarter. This is reflected in the performance of the two key benchmark indexes for small cap stocks in Canada, being the S&P/TSX Small Cap index which was down -4.3% for the quarter, and the Nesbitt Burns Small Cap index which fell by –4.0% over the same period. The Brownstone Small Cap model portfolio declined generally in line with these benchmark indexes returning -3.8%. Three particular small cap stocks had poor returns for the quarter which impacted our performance this quarter; Wireless Matrix, Equitable Group, and Creo.

Our strategy with regards to the inclusion of small cap stocks in our portfolios has not changed. While small cap stocks can be volatile, we believe there are more opportunities to achieve superior returns in this space. In general, the valuation swings can be more extreme in smaller capitalization companies. This reality means they can become excessively undervalued or overvalued at certain points in the cycle when compared with equivalent large capitalization companies.

A new name we have been adding to Brownstone portfolios recently is Chartwell Technology. It is a Calgary-based company which specializes in providing internet gaming software to large gaming companies. These companies are mainly European based, where online gaming is becoming more acceptable to regulators and public alike. The company is virtually unknown by the broader markets. In its last quarter, the company achieved recurring revenue that exceeded its fixed costs by a meaningful amount, showing a nicely profitable quarter. Its recurring revenue is growing rapidly, while expenses are growing at a much slower pace. We believe the market has overlooked this company and, with a few more quarters showing a continued uptrend in recurring revenues and earnings, the market will have to take notice. The market capitalization of Chartwell is only $50 million and illustrates clearly where we intend to provide value to our clients. We can take a meaningful position in a company of this size, while this opportunity may not be available to many of our larger competitors. Over time, we believe participation in this segment of the market will provide our clients superior returns.

The small cap equities that we purchase require much analytical diligence, which includes company visits and regular communication with CEO's and CFO's of these companies. We monitor company progress closely and review relative valuation levels against our initial investment thesis. The success of Brownstone will always be predicated on extensive research, combined with experience, to create portfolios with a goal of delivering above average results.

While predicting overall markets is fraught with risk, we believe we are in for a fairly volatile summer. Concerns over high energy prices and the potential for rising short-term interest rates have made equity markets nervous. In general though, we believe that equity markets still provide reasonably attractive valuations at this point. With interest rates at very low levels, multiples for stocks remain generally quite attractive.

Bond Market Chills Over Rate Hikes

Expectations of a rate increase became a reality at the end of June, sending bonds valuations down in the first two months of the quarter. After a tremendous first quarter, the bond market collapsed in April, eliminating most if not all of the gains from the previous three months. June's modest recovery, as the economic news, again became mixed, offset most of the losses incurred in May. The total bond market return over the quarter, as measured by the Scotia Macleod Bond Universe, was –2.02%. This was one of the worst quarterly readings for that index in ten years. It is important for investors to realize that a negative move in the capital value of a bond is only relevant if the security is traded, otherwise by holding the bond through to its maturity date, the security will generate a return equal to its yield to maturity. The yield to maturity of the Brownstone Capital model bond portfolio is just over 4%.

Increasing signs of inflation and a strengthening economy became the focus in late June as the Fed met and raised interest rates for the first time since 2000. While the market had anticipated the move for some time, the comments that accompanied the announcement were closely read for indications of further rate increases. The statement of a "measured" pace of increases means that rate hikes will likely continue and generally take place in quarter point increments.

At Brownstone, we continue to ride the "short end of the curve", that is, we have emphasized shorter maturities in our fixed income portfolios for purposes of preserving capital. The third quarter will continue to be dominated by macro economic themes we have seen so far this year: Iraq, the price of crude oil, and forthcoming elections in the U.S.