



Energy and Financials Carry the TSX Ball Forward in 2005

The fourth quarter of 2005 was volatile by most measures. We witnessed a strong market pull-back in October mainly attributable to energy and income trusts with the TSX retreating over 5%. The market reversed its tracks in November, and with further positive momentum in December, the index closed the quarter up 2.9%.

As we close the year 2005, the Brownstone Canadian Equity model returned 18.72%. The strongest attribution of returns from the portfolio was generated from the financial services sector which returned 22.4%, and the energy holdings at 58.56%. These two sectors represented approximately 60% of the invested capital of the portfolio. This same equity program delivered 27% in 2004. While we are pleased our main Canadian equity program at Brownstone returned 47% over 2004 / 2005, we expect that 2006 may deliver more modest returns. From a risk adjusted viewpoint, we are still comfortable that equity valuation levels today can be supported by forecasted earnings.

Clearly 2005 was a year full of momentous events from a number of aspects. Natural disasters were prevalent and large scale, and the world entered a new energy crisis. The price of crude propelled to new highs as hurricanes blasted energy infrastructures and Middle East unrest continued unabated. While these events supported investments centered in the energy sector, they also ushered in renewed concerns regarding inflation and the potential reduction in global economic growth. The impact of these events, while tragic in so many ways, put the domestic investment front here in Canada into play. Riding the wave of rising crude and natural gas prices, the Canadian dollar and Canadian equity markets rallied throughout the year; our dollar has been one of the best performing currencies world-wide through 2005. Over 2006 we can expect a relatively strong correlation between the price of crude and performance of our dollar.

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**Bob Thompson
President & CEO**

At its peak in 2005, the energy sector represented close to 30% of the Toronto Stock Exchange Index. This is reminiscent of the days when Nortel alone represented over 30% of the index. The current composition of the S&P/TSX Composite Index will result in index volatility levels being linked, to a certain extent, to the performance of commodity prices. At Brownstone, we structure portfolios in a manner to temper this volatility. While we have enjoyed robust returns from our energy holdings, which account for approximately 23% of our equity exposure, we believe it is prudent to limit invested capital to commodity-based investments. We continue to emphasize well diversified portfolios, with a range of equities spanning all capitalization ranges. A number of the banks and insurance companies have excellent dividend yields which will likely enhance returns once the planned improved dividend tax credit is implemented. The specter of bank mergers may be back on the table with a change in the Federal Government.

In Canada, 2005 was a year where the large cap market provided stronger returns than the small and mid cap sector. The top 60 largest companies on the index returned 24.8%, primarily dominated by energy companies. The TSX small cap sector returned 9.4% over the year. At Brownstone we invest in a range of capitalizations. We expect higher growth rates from small companies and accordingly seek to invest about 20% - 30% of our capital in this market range.

Yield Investments - Bonds and Income Trusts

Fixed income investors ended the year with limited clarity about the future. The Bank of Canada raised rates twice over the quarter, totaling 0.5% for the year. There is debate and speculation over whether we will see continued rate hikes in 2006. Inflation data continues to surprise on the downside, despite higher energy costs to consumers and robust consumer spending. The retirement of Alan Greenspan looks timely as U.S. fiscal policy is looking strained and the war in Iraq is showing little signs of progress. U.S. consumers continue to purchase foreign goods (China), and the red-hot housing market looks aged. The best scenario for the bond market will be a soft economic landing should we embark on a recession. This occurred in 1995 and delivered excellent bond and equity returns.

We continue to manage our fixed income portfolios with conservative maturity schedules. Over the quarter we extended term on a number of fixed income securities with maturities over the next two years. We work towards maintaining yield for our clients yet mitigating the risk of continued rate hikes.

The dominant story over the course of the year was the flattening yield curve. As the Fed continued to raise short term rates, the longer term rates stayed relatively flat. The current shape of the yield curve has been indicative of five of the last six recessions in the U.S. We may be close to the end of the rate hike cycle. The general rule for the year was that longer term, higher quality bonds turned in the best results.

The Federal political scene in Canada has been positive over the quarter. With the presence of a minority Government and the imminent federal election, we expect the previously announced improved tax structure on dividends and trusts to remain. Pressure from the investing public and noises from our large chartered banks forced the hand of Ralph Goodale to come to grips with dividend taxes and trust distributions. Despite the weak minority Government, such weakness was beneficial to investing in these sectors.

Brownstone Executive Team



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