



## Financial and Materials Stocks Do the Heavy Lifting in 2006

Global economic growth was strong over 2006 and contributed to positive returns from many of the capital markets around the world. Here in Canada, the S&P / TSX composite index enjoyed its fourth consecutive year of double-digit growth primarily on the back of strong financial and materials stocks.

Our investment strategy at Brownstone remains consistent. We seek to maximize financial returns while managing the level of risk associated with our portfolios. In that regard, we keep a close eye on the individual investments that we participate in as well as the amount of capital exposed to the various investment sectors. Over 2006 our largest exposure was to the financial services sector with approximately 40% of our capital invested in banks, insurance companies, alternative lenders, investment management companies, and investment dealers. We enjoyed a 27% return from that sector which contributed to our year end return of 14% in the Brownstone Canadian Equity model portfolio. Our investments in the materials sector which include nickel, copper, zinc, and uranium were outstanding at over 105% return. Although we were pleased with these investments, we reduced our position in January 2007 as we are most cognizant of the potential volatility that is associated with the materials sector.

Our results in the energy sector underperformed the energy index due to exposure to mid-cap natural gas companies which lost value in light of a steep decline in natural gas prices over the second half of 2006. We have long ascribed to a limit in energy holdings given the cyclical nature of commodity prices. The robust move appears to be over in the energy sector for the time being, although the world's insatiable appetite for crude will not abate. The energy sector in Canada has a bright future; however in our view structural problems will plague the industry for sometime. Commodity volatility aside, the sector will continue to wrestle with problems of hyper-cost inflation, human resource challenges, and government interference. On top of these challenges the environment seems to have surfaced as a key political chess game where our politicians are eyeing the environment as a plausible platform to collect and redistribute Alberta's burgeoning wealth into other national interests. Despite the challenges, there remains a number of exciting energy prospects that we will participate in. We currently have an 18% capital exposure to the energy sector and consider that to be at the top of our desired range.

On October 31, 2006, Finance Minister Jim Flaherty announced plans to impose taxes on income trusts to halt a slide in tax revenue. The S&P Income Trust index lost over 12% in two days. At Brownstone our primary income trust investments centered on REITS (real estate investment trusts). These trusts were exempt under the ruling and as a result our clients largely avoided the financial impairment cause by this ruling.

## U.S. Market Strategy

Over the course of 2006 our Brownstone investment team developed an investing mechanism for capital deployment in the U.S. equity market. We embarked on this project for three primary reasons. Firstly, we recognized that the Canadian market is narrow; its makeup is heavily skewed towards resource holdings and financial services. Secondly, the Canadian market has enjoyed a record five years of out-performance over the S&P 500 which historically is not the norm. This was primarily due to the rise of commodity prices and a strengthening Canadian dollar. Thirdly, the U.S. equity market remains the largest equity market in the world with a sea of companies, small, medium and large, conducting a wide range of business.

The Brownstone American Total Return LP will be launched April 1, 2007. This investment vehicle will participate solely in U.S. securities. It is unique, as we have developed a proprietary system for selecting U.S. equities. We are utilizing a sophisticated mechanical screening process that essentially reduces a body of close to 2000 stocks down to a select 36 holdings. The screening process will occur quarterly with adjustments made to the portfolio at that time. We have back-tested the results to 1989 and they are most impressive with substantial out-performance over the S&P 500 in virtually every year.

We are pleased to announce the addition of Shannon Purvis to our Brownstone team. Shannon will be a great addition to the management of our growing firm.

### **Brownstone Executive Team**



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