MUTUAL FUNDS update

SUMMER 2004

It's Summer: Do You Know Where Your Mutual Funds Are?

by Pierre Saint-Laurent, M.Sc., CFA, President, AssetCounsel Inc.

Summer's a great time for a number of things: gardening, swimming, traveling and cottage-country quality time to name a few. And, summer is when we can spend more time on the items we had to set aside during the busy work year in order to be ready to start anew come fall.

Financial matters are no different. We typically rush through our obligations all year long. When summer beckons, we are all too happy to change the pace until September. But the slower months of the year are an excellent time to take stock and tidy up for the next upcoming rush.

In particular, you may want to take a deeper look at your mutual fund portfolio. First, you might want to assess the behavior of your assets over the past year: was it a good or great year? Was it a bad one or was it 'ok'? Importantly, why? Is it due to specific conditions, such as a market comeback, one-time tax cuts, or monetary policy? Is it due to decisions made in your portfolio? Making a habit of checking at the same time of year, typically when other things quiet down, is tantamount to businesses finishing their fiscal year and preparing to report, which may mean taking inventories, closing accounting records and the like. It's preferable to do so when not overly busy with other preoccupations. What you'll gain from it is an accumulation of knowledge on how your portfolio behaves and a better understanding of what you expect, seek and fear from your investments.

Second, you may want to review your portfolio from a 'bottom-up' approach. This means revisiting your portfolio's asset allocation from two perspectives: an asset class perspective and a rebalancing perspective. You want to ask yourself if the asset classes you're invested in still correspond to your needs and objectives, both short-term and long-term. One of the most important elements is your time horizon, which means the time at which you will need access to your assets; for instance, at retirement. How long is your time horizon, or for example, how far from retirement are you? This is a crucial question, as it largely determines how aggressive you can afford to be with your investments.

Another question is how sensitive you are to portfolio variations. Have recent events taken their toll on your serenity? Do you wish you hadn't invested in certain funds or assets? It's time to take stock and possibly amend your asset allocation. Keep in mind, though, why you've selected an asset allocation in the first place: to allow you to maximize risk-adjusted returns, over your own time horizon, while sleeping at night. If any of these elements have changed, it's time to take a second look.

And now for the rebalancing perspective: an asset allocation is a long-term template to help you attain your objectives. However, by the mere fact that different assets don't all have the same returns, the relative weighting of these assets in the portfolio is bound to change from your initial allocation. The portfolio will sooner or later become unbalanced. Why is it important to rebalance it regularly? So that your customized 'blend' of assets remains on your long-term track within your time horizon. Also, rebalancing amounts to 'selling today's winners and buying tomorrow's winners'; inasmuch as there is a mean reversion in asset returns (a tendency to do relatively well after doing relatively poorly, bringing average returns in line with long-term averages), selling when assets have done well and buying those that are at lower values is an effective tactical play on markets. This is what rebalancing allows you to do in a systematic fashion. So rebalance your portfolio at least yearly, another great summer to-do.

Yet another worthwhile insight to gain is in terms of increasing your portfolio's diversification and accessing new products. You may want to consider asset classes you haven't looked into before. Some examples are European stocks, foreign bonds, or international small-cap equities. Remember, mutual funds give you access to certain investments that would be costly, difficult or even practically impossible for you to trade. As well, you might want to consider the newer types of investments to have come to the market. One example is tax-efficient funds: typically structured as corporations, these products allow you to manage your asset allocation effectively without triggering tax consequences when rebalancing.

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India and Russia – Overlooked Growth Leaders of Tomorrow

Contributed by:
Capstone Funds

Are you investing in countries that will be the growth leaders for decades to come? China may currently be garnering most of the attention, but are there others with equal or greater growth potential?

The answer is yes. While China has been experiencing unprecedented growth, other underdeveloped and often overlooked countries are missing from many investment portfolios.

The case for India and Russia

From a population and economic growth standpoint, China is by far the world leader. However, India, with over a billion citizens rapidly becoming more educated and well trained, may outpace the economic expansion China has experienced. India's growth rate is actually predicted to outpace China's over the next 30 to 50 years. With India's GDP expansion estimated at greater than 5% for the next 30 years, the former British colony would have the third largest economy in the world behind only China and the U.S. (based on US$ GDP)*.

Russia, a more developed nation compared to India, still has great growth potential with its massive energy resources, manufacturing capability and educated labour force. Russia is currently the second largest oil exporter in the world, and is supported by a prudent government running a balanced budget and a payment surplus. With inflation declining, coupled with strong domestic savings habits and reduced interest rates, the domestic economy should strengthen over time and provide solid support for Russian equities. It is expected that the Russian economy will overtake those of Germany, France, Italy and the UK* in 30 years.

As much as one third of the GDP expansion for both India and Russia will be attributed to rising currencies. The Indian Rupee and Russian Ruble are expected to appreciate 281% and 208% respectively over the next 50 years*. Much of this expected currency appreciation will rely on several variables: increased foreign investment, privatization of state run enterprises, rising domestic demand and incomes, and large increases in the weight of these and other developing countries in investment portfolios.

Risks and volatility

There is obviously a strong case for long-term investment in Russia and India, but along with that opportunity, there will be risk and volatility. The recent political events in India that closed trading on the Sensex and the banking crisis in Russia are evidence of continuing short-term risk associated with investing in these markets. Although these events should not impact the long-term growth prospects in these countries, it is imperative to match your investment time frame with that long-term perspective and regularly monitor the macro conditions and local financial market nuances. This is where mutual funds can help.

Access to foreign markets – a great benefit of mutual funds

Thanks to the broad selection of investment choices provided by direct investing firms such as BMO InvestorLine, access to investment choice has never been easier for the individual investor. For investors seeking to purchase individual securities in global equity markets however, access remains limited and costly. One of the ways individuals can take advantage of the growth opportunities in India and Russia are through mutual funds. Mutual funds can provide easy and cost-effective access when investing globally.

Capstone Global Equity Fund provides access, with reduced risk

John Weatherall, the forty-year fund industry veteran who recently joined the fund management team on the Capstone Global Equity Fund (formerly the Capstone International Equity Fund), observes that India and Russia not only have great growth ahead of them but they also have strong corporate stewardship and trusteeship that is difficult to find in many other emerging markets. India, for instance, still uses the British Company Law system with its strict regulations and disclosure requirements. Recent turmoil in Russia surrounding Yukos and the liquidity of small independent banks illustrate how vital Mr. Weatherall's focus on stewardship is. Mr. Weatherall also feels there are great values to be had in these markets today, with many companies priced at attractive levels.

The Capstone Global Equity Fund is positioned to take advantage of specific emerging market opportunities, as well as managing risk by diversifying holdings into more established economies. Mr. Weatherall believes it's wise from a risk and volatility perspective that investors are not overly exposed to individual markets in their portfolios. A diverse, global equity fund like the Capstone Global Equity Fund would be one of the best ways for individuals to participate in the outstanding but volatile growth stories of tomorrow.

**Goldman Sachs, Global Economics Paper No: 99, October 2003.*

Contributed by:

MORNINGSTAR®

David O'Leary

Why Gold's Glittering Run Isn't Over

More than three years into a bull market for gold, investors can't help but wonder when bullion will reverse its course. Despite gold's high volatility, however, investors should not take this as their cue to bail out of bullion or precious metals funds.

Gold still has its place in portfolios, largely as a defensive asset class. Exposure to gold can help ease the impact of a resurgence in inflation or offset currency depreciation.

The rising gold price is being driven by the following factors:

- **Continued U.S. dollar weakness:** In the 1990s, the U.S. dollar was seen as a safe haven for capital. When there was economic uncertainty or geopolitical turmoil, investors would flock to the U.S. dollar (via U.S. Treasury bills) to avoid collapsing prices in various other assets such as equities, real estate and other tangible goods. Since the U.S. dollar has depreciated considerably in recent years, gold has taken over as the safe haven of choice. Precarious levels of U.S. debt have fuelled the recent decline in the U.S. dollar. The U.S. current account deficit and the large budget deficit have become quite alarming. The problem is that the U.S., through trade and capital flows, has a considerable amount of money leaving the country. This means the U.S. must attract larger amounts of foreign capital to make up for this loss and the reasons why foreigners would want to continue piling so much money into the U.S. are becoming less clear.
- **Increased demand, fixed supply:** A continued gold run would also likely be fuelled by the current supply and demand situation. Gold supply has been largely fixed since the required mining and extraction process takes years to actually produce gold. The central bank source of gold supply is also largely fixed, since the European Central Bank and other European central banks recently renewed their 1999 agreement with Washington to limit gold sales among member nations to 500 tonnes annually for the next five years. Meanwhile on the demand side of the equation, both the Chinese and Japanese central banks have been actively buying gold to increase their reserves. In addition, the fact that interest rates are very low also contributes to the growing gold demand. This means that investors are not giving up significant income potential from other investments by putting their money in gold.
- **Tensions in the Middle East:** Since gold has once again become the de facto store of value, continued geopolitical turmoil would support the price of gold. Gold has repeatedly surged on developing news regarding terrorist activity in the Middle East. Continued terrorist activity could potentially lead to further surges in the price of gold.

The biggest risk to gold would be for the U.S. dollar to reverse its course and begin appreciating. Easing tensions in the Middle East and an improved U.S. trade deficit would probably contribute to gold's decline. However, the U.S. trade deficit is unlikely to improve dramatically without at least a modest depreciation of the U.S. dollar. And it is unlikely that geopolitical tensions, especially those in the Middle East, will disappear overnight.

The case for precious metals funds

Since gold acts as a store of value when the U.S. currency is falling and inflation is rising, it seems only prudent to hedge your bets by having some direct or indirect gold exposure. But how best to do so? For reduced risk and potentially higher returns, holding precious metals funds is a much more viable alternative.

The reason: gold stocks are even more volatile than the price of gold itself. Gold funds help mitigate this risk through portfolio diversification and professional management. Bear in mind, though, that precious metals funds are extremely volatile and therefore are not suitable for everyone's risk tolerance and time horizon.

Even so, one of gold's most important attributes is its extremely low correlation with both equity and fixed income markets. For that reason, adding gold exposure to your portfolio can reduce overall portfolio risk and enhance returns. However, a little bit of gold goes a long way. Most investors should limit their gold exposure to no more than a 5% to 15% range.

David O'Leary is a senior analyst with Morningstar Canada.

An Introduction to Pure Growth Investing

Contributed by: Stone & Co. Limited

Investing style can basically be broken down into four groups: growth, value, a blend of the two and market-focused investing, such as momentum or sector rotation. Value style managers look for shares that are under-priced compared with what the managers believe is the true value of the issuing company. Growth style managers look for companies where they believe the earnings and, hence, stock price will rise at a rate that is faster than that of similar companies.

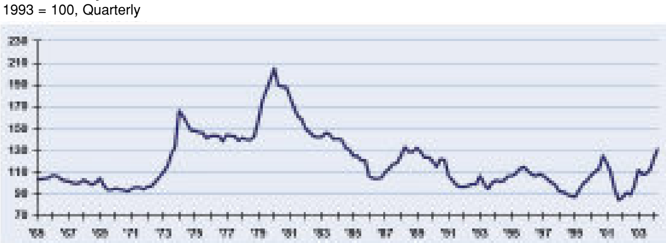
Growth investing is the dominant and arguably the most successful investing method. Growth managers buy businesses that can sustain above-average earnings growth over the long-term. That is, these businesses should grow faster than their industry peer group and the market as a whole. Selecting large-cap growth stocks (i.e. as ranked by market capitalization) generally means picking the industry leaders, another positive for investment success.

However, most Canadian growth funds hedge their bets by including cyclical stocks in their portfolios. Cyclical stocks include base and precious metals, and forestry issues. The disadvantage of cyclicals is that they tend to rise quickly during an upturn in the economy and fall quickly during a downturn. Cyclical companies simply are not growth businesses – their stock prices are almost always a reflection of commodity prices.

According to the July 2004 BMO Financial Group Commodity Price Report, while commodity markets have enjoyed a rally since mid-2002, they declined 3.6% in June 2004, a cooling off which is expected to continue.

Commodity prices in long-term downtrend

All-Commodity Index, Real U.S. Dollars*
1993 = 100, Quarterly



* From the BMO Financial Group Commodity Price Report, July 2004.

Canada's changing economy

As Canada evolves from a commodity-based economy to a globally-focused technology, industrial and service economy, there is further opportunity to invest through growth. Take for example, the unique growth mandate of the Stone & Co. Flagship Stock Fund Canada, defined as Pure Growth®†, which primarily focuses on Canadian growth companies with a global perspective. That is why there are no so-called deep cyclicals – "no trees, no rocks, no gold®†" – in the fund's portfolio. The rationale: deep cyclicals are not global long-term earnings growth companies; therefore, they cannot provide sustainable share price appreciation.

Among the resource group, the fund makes one exception: energy stocks to hedge against inflation. Stone Asset Management believes natural gas is a long-term energy solution for North America because it's a clean fuel and relatively easy to ship. In addition, oil and gas are not as susceptible to the build-up of inventories, which can undermine a commodity's price. The fund's oil and gas holdings highlight its focus on Canadian businesses with global operations. These companies are in a good position to take full advantage of accelerating growth in the world economy.

The lead portfolio manager for Stone & Co. Flagship Stock Fund Canada is Chyanne Fickes. Since taking over management of the Fund at the end of 2002, Fickes has swiftly moved the stock selection and overall performance of the Fund into top quartile returns.

Stone & Co. Flagship Stock Fund Canada

Compound returns and quartile rankings*: Series A Units

YTD	*1 Mth*	*3 Mth*	*6 Mth*	*1 Yr*	*3 Yr*	*5 Yr*	*Since Inception*
8.4	2.3	3.5	8.4	22.7	1.3	5.2	7.8
1	1	1	1	2	4	3	n/a

* Source: PALTrak as of June 30, 2004

Investors, who want to further diversify their portfolios by investment style, may want to consider a Pure Growth mandate. By avoiding deep cyclicals, buying companies with strong global presence and long-term growth opportunities, the Stone & Co. Flagship Stock Fund Canada offers a nice complement to any investment portfolio.

®† "Pure Growth" and "No trees, no rocks, no gold" are registered trade-marks of Stone & Co. Limited.