

Notes

Nexus Investment Management Inc.
Portfolio Management & Financial Counsel

Inside Articles

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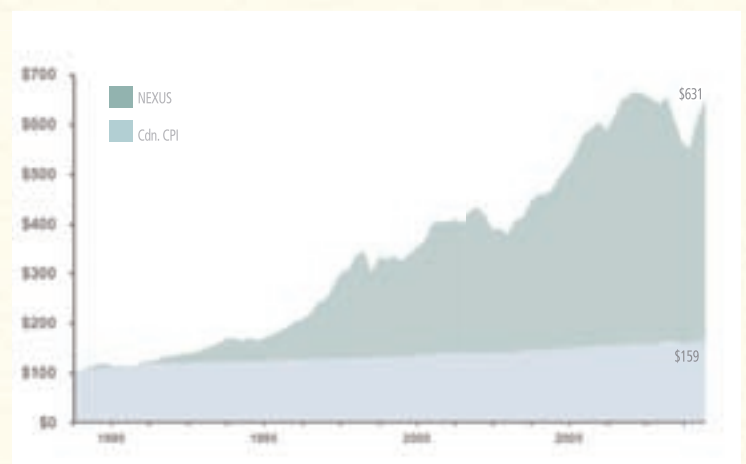
U.S. ESTATE TAX UPDATE – WILL THE LAW BE REPEALED IN 2010?

PEARLS OF WISDOM

Building Value for Clients

Since its establishment in 1988, Nexus has pursued an investment approach which concentrates on real growth in client wealth over the long term. The chart illustrates the impact of this long-term investment thinking – a \$100 investment in a balanced portfolio in 1989 has grown to \$631 at September 30, 2009.

\$100 Investment with Nexus in 1989



2000-2009: The Spills Outnumbered the Thrills

The first decade of the 21st century is coming to a close and it has proven to be remarkable in many ways – politically, economically and financially. It started with a wimper, rather than a bang, when the Y2K scare or ‘millennium bug’ didn’t result in widespread computer failure, as feared.

However, from that point on, a number of unfortunate events began to unfold, indicating that challenging times were upon us. We experienced the horrific acts of violence on September 11th, 2001 with the terrorist attacks on U.S. soil. This resulted in Bush’s ‘War on Terror’, and the subsequent wars in Iraq and Afghanistan. Let us not forget events like SARS in 2002, the Tsunami in the Indian Ocean in 2004 that claimed 200,000 lives and, most recently, the H1N1 scare.

Financially, at the start of the decade, investors discovered that the technology boom turned out to be nothing more than irrational exuberance. Hurricane Katrina helped fuel the fear of dwindling supplies of oil and gas, resulting in soaring prices and renewed interest in Canada’s energy resources. While the oil and gas industry experienced staggering profits, consumers felt the impact at the gas pumps. Then came income trusts – after being part of the Canadian investment landscape for years, the government changed the rules regarding how they would be taxed. This translated into a total trust sector market capitalization loss of over \$33 billion.

In the fall of 2007, the loonie hit parity with the American dollar for the first time since 1976. Around the same time, concern emerged over the state of the U.S. housing and sub-prime mortgage markets. Financial markets began reacting to rising mortgage defaults. At that point the immediate cause of volatility in the stock market was sub-prime mortgages. However, concerns soon spread to many types of structured credit products. A litany of financial companies around the world were announcing a never-ending series of big write-offs.

The tail end of last year culminated in a perfect storm as panic and despair spread from credit markets to equity markets the world over and stock markets went into a freefall. As 2008 drew to a close, we faced the grim prospect of a prolonged global recession – since dubbed the “Great Recession”.

So here we are at the end of another year and decade of adversity – hopefully at an inflection point. The stock markets are strongly suggesting that an economic recovery is on the horizon while government balance sheets and unemployment levels look awful. If we look at U.S. data since 1929, we see that the average bear market lasted 19 months and pruned 37% off the price index. It then took an average of 33 months to reclaim the previous peak.¹ If March 2009 turns out to be the bottom of the market, then we are still in for a lengthy recovery.

In November, we hosted our annual client event over two evenings at the National Club. The message in this year’s presentation was “Keep Calm and Carry On” in the face of adversity. Each presentation ended with client questions on an interesting array of topics. We have shared our answers to two of these questions with you in this edition of Nexus Notes.

Also in this edition is a follow up on two unresolved tax issues. One is the status of GST on portfolio management fees and the second is U.S. estate tax on the eve of the year in which the estate tax is meant to be zero.

On behalf of the partners and staff here at Nexus, we wish you and your families health and happiness throughout the holiday season and in 2010!



DCW

¹ “Getting back in the game”, by Garnet Anderson, CA Magazine, November 2009

The Waiting Game – GST Act II

If our first article about the GST back in June had a Shakespearian theme to the title (“GST – To Be or Not to Be...”), this update has more of a “Waiting for Godot” flavour to it.

What’s happened in the intervening months? Lots. And not much.

As those for whom Nexus manages investments already know, the decision by the Canadian Federal Court of Appeal in the *Canadian Medical Protective Association* case was not appealed to the Supreme Court of Canada. Thus, that court decision re-wrote the law as it applies to GST on discretionary investment management fees. We, like most industry participants and their legal advisors, fully expect the Federal Government to change the law *back* and thereby *re-impose* GST on such fees, and possibly to do so retroactively. Until then, however, we believe that the right thing to do is to respect the authority of the court and stop collecting GST. We also equipped clients with the materials necessary to request the Canada Revenue Agency (“CRA”) to rebate the GST paid on the last two years’ investment management fees.

Since then it is striking what hasn’t happened, as opposed to what has.

First, although many investment managers recommended that their clients apply for a rebate of the GST paid in the last two years, we are not aware of any other manager who, like Nexus, has stopped collecting GST from client accounts. We find this remarkable. To, on one hand, advise clients that they should apply for a rebate but, on the other, continue to collect the tax seems completely contradictory. Perhaps other managers have preferred the status quo or path of least resistance? Interestingly, we understand that two firms that have continued to collect GST have recently been served with a lawsuit for doing so.

Second, despite expectations that the Federal Government would act quickly, the Department of Finance been slow to announce any new legislation to re-impose GST on discretionary investment management fees. It may be that a Federal reaction has been delayed by efforts to develop a coordinated response with the six provinces that are or will be participating in a harmonized GST and provincial sales tax – the so-called harmonized sales tax or “HST”.

Third, to our knowledge, the CRA has neither approved *nor denied* any of the GST rebate applications submitted by Nexus clients or by clients of other investment managers. It may be that the CRA has been overwhelmed by the number of applications, or that they are simply delaying until the Department of Finance signals what sort of legislative “fix” is planned.



RDC

BREAKING NEWS

On December 14th the Department of Finance announced that the Government will shortly be tabling new legislation that will (i) re-impose GST on discretionary investment management fees, (ii) deny claims for rebates of GST previously paid on such fees, and (iii) waive any obligation to pay GST that has not previously been collected. As a result of this development, and subject to our review of the draft legislation when it becomes available, we expect to resume charging GST on our fees with the billings in January.

What Our Clients are Asking About....

In November, we hosted our annual client event where we shared our views on the challenges of the past year, an assessment of the current environment and the resulting investment implications. Following the presentations by Nexus partners, our guests asked many interesting and thought-provoking questions. For readers who did not attend, here are two topics worth revisiting.

AS GOOD AS GOLD? IS GOLD A GOOD INVESTMENT AT THIS POINT?

With the gold price soaring recently, so too has interest in the yellow metal. Is there a long run ahead for gold or will this be another bubble?

An investor can buy gold as a long-term investment, with hopes of a shorter-term trading profit, or for portfolio “insurance”.

- As a long-term investment, gold is as bad as it gets. The reason being, unlike other investment assets, it offers no yield. Over long (multi-decade) investment periods, gold has been *the* worst asset class to hold. Stocks, bonds, real estate, timber, and even cash earning short-term interest, have all outperformed gold. As an investment, gold is simply un-analyzable. Its price is based on psychology – the endlessly shifting and unpredictable “animal spirits” of the market, as John Maynard Keynes termed it. For other investments, value can be gauged by comparing expected future cash flows with the current price.
- Thanks to these animal spirits, gold can be a very profitable short-term trade. However, to do so requires that it be bought *and* sold at the right time. More easily said than done! By definition, sentiment is poor and few think it a good idea to buy gold when the price is low and vice versa when it is high. Success requires making good contrarian

bets....twice...in a row...and then either doing it again, or not, lest one get the wrong end of the stick the second time around. Looking back at the 1980 peak demonstrates just how quickly things can change. Gold ran from \$300 an ounce to \$850 in five months and was back below \$500 a couple of months later. Guess when the line-ups at bullion traders were the longest?

- There is a rationale for gold as portfolio insurance: it’ll skyrocket if everything else – equities and bonds – blow up. Also, it will help maintain real purchasing power if unexpected inflation eats away at the value of bonds. The problem is, for the insurance to be meaningful, gold needs to be a substantial component of the portfolio. As such, the *cost* of the insurance is high. In this context, the cost is the lost return (the economist’s ‘opportunity cost’) on the bullion holding when the portfolio is doing just fine. Witness the 20-year sideways grind in gold from the mid 1980’s on.

OK, back to today. With the massive structural U.S. fiscal and trade deficits, super low interest rates, and a depreciating US\$, gold certainly has a tailwind. Inflation may not be an issue today, but some see it in the tea leaves. On the other hand, this view appears to be the consensus, so where is the contrarian bet? So, is gold a good buy? Perhaps. You can bet on that!



FWG

Investments cont.'d

THE HEALTH OF HEALTHCARE IN THE U.S.? WILL GOVERNMENT INTERVENTION BE TOO MUCH?

In light of the likelihood of increased government regulation, can you explain Nexus's strategy with respect to its U.S. healthcare investments?

Nexus has had a significant weighting in healthcare for a number of years. We like the industry for a number of reasons, but particularly because it is less cyclical than the broad economy. Put another way, people get sick and consume healthcare services, whether the economy is expanding or contracting. Looking longterm, there is natural growth in the sector from the demographic trend of an aging population.

Many parts of the U.S. healthcare industry are very international in orientation. Many of our holdings generate more than half of their revenues outside the United States and changes in the U.S. market have less of an effect than some might imagine. Additionally, while these companies report their results in U.S. dollars, their profitability can actually benefit if the U.S. currency weakens further. Medical equipment and services is an area where the developed-world has a technological lead on the less-developed world. As countries such as China and India develop economically, they will utilize more advanced medical products.

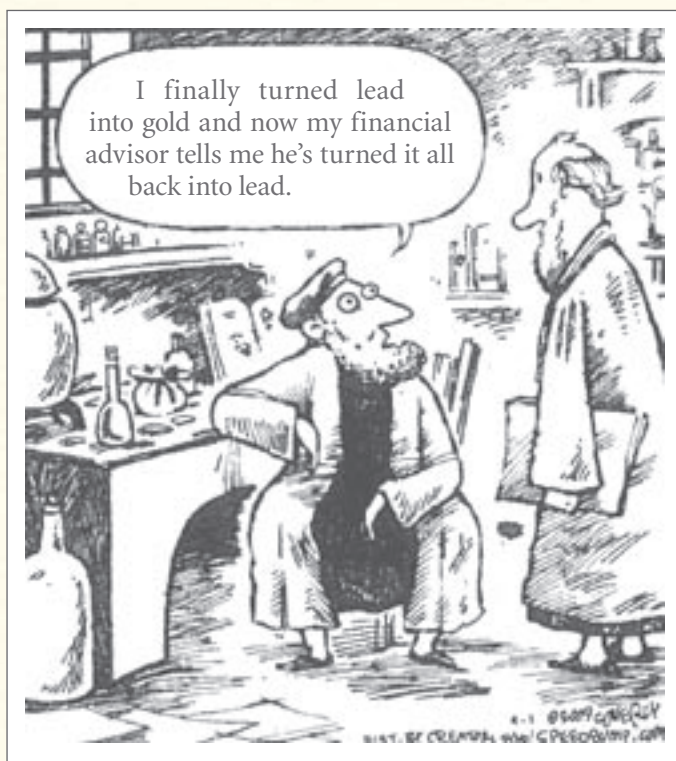
The coming changes to the regulation and delivery of healthcare services in the U.S. bears close watching. For all of its defensiveness, it is an industry with high 'stroke of the pen' risk. Balancing some of the concern of government interference is that, by some estimates, as many as 34 million Americans not currently covered in a medical plan will be brought into the healthcare system. We own two companies, Davita Inc. and Lincare Holdings, which each deliver medical services solely inside the U.S. and will be broadly affected by the changes that are coming. Davita is one of two companies that together dominate the delivery of kidney dialysis services in the U.S.

We think its valuation already discounts a lot of bad news and we are comfortable owning it. Lincare is far and away the dominant and low-cost provider of COPD¹ services in the U.S. and its competitive position might actually benefit from changes that are to come by enabling the company to acquire smaller competitors at attractive valuations.

We would like to have these kinds of investments as part of our Canadian portfolio, but there are no real candidates in Canada for inclusion. The healthcare sector here is very small and is characterized by companies in early-stages of development. I think it is fair to say that there are no Canadian companies of global stature in the healthcare space – certainly none that would meet Nexus's investment criteria.



GJG



Barron's

¹ COPD is an acronym for Chronic Obstructive Pulmonary Disease.

U.S. Estate Tax Update – Will the Law be Repealed in 2010?

U.S. estate taxes can impose a very serious burden on Canadians who own property situated within the United States, including U.S.-listed securities. There has been uncertainty around the U.S. estate tax rates and exemption due to legislation that was passed back in 2001.

In particular, many want to know if the pending repeal of U.S. estate tax that is expected to occur on January 1, 2010 will actually take place. In 2001, the U.S. changed its estate tax law. At that time, the top estate tax rate was 55% and the exempted estate amount was US\$1 million. The change was to gradually reduce the highest estate tax rate from 55% to 45% and increase the size of an exempted estate from US\$1million to US\$3.5 million, with the tax reductions to occur over the 2001-2009 timeframe. The other significant change was the complete repeal of estate tax effective January 1, 2010. In addition to the repeal, a 'sunset' provision was put in place whereby on January 1, 2011, the estate tax law will revert to the 2001 rates. The repeal and sunset provisions were designed to ensure that Congress would have to enact a replacement law before December 31, 2009.

As we approach the end of 2009, Congress can't seem to make up its mind how to proceed. However, it is unlikely that 2010 will be the year of 'no U.S. estate tax'. It was anticipated that the 2009 exempted estate size of US\$3.5 million and the highest tax rate of 45% would be made permanent without indexing. Now, it appears more likely that a one year extension will be passed, keeping the 2009 estate tax rates effective through to the end of 2010. This will allow Congress to postpone dealing with this difficult

issue until later in 2010 when it will also need to address the expiration of other tax breaks for U.S. citizens that were put in place in 2001 and 2003.

For Canadians, U.S. estate tax can apply to a deceased's 'taxable estate'. The taxable estate is defined as the gross value of property situated in the United States (most commonly U.S. securities and real estate) less any allowable deductions on the date of death. The estate tax is applied to U.S assets at graduated rates. Canadians are also entitled to the exemption; however, most Canadians are not entitled to the full amount. This is because the exemption is pro-rated by the proportion of U.S. assets relative to the deceased's worldwide assets.

Canadians holding U.S. assets should be aware that U.S. estate tax exposure still remains and should take necessary planning steps to limit that exposure.



DCW

Pearls of Wisdom

Reading is one of the principal occupations in our profession. As the group of us digest a wide range of material, interesting ideas and surprising facts – some serious and some light-hearted – rise to the surface. We attempt to share a few of those with you in each of our issues of Nexus Notes.



JCAS

- Since 1979, an average of 11 out of every 100 commercial bank branches have been robbed each year in the U.S. Despite the deep recession in the past year, that number has dropped to 6 out of every 100 branches. Many security experts believe the explanation is simple. An increasing number of banks employ Walmart-style greeters that smile and look each customer in the eye. The bad guys are losing their nerve. (*Forbes*, November 30, 2009.)
- It is estimated that 23% of U.S. homeowners have mortgages that are under water – meaning that the amount owing on their mortgage is greater than the value of their house. (Recently, the methodology used to calculate these statistics changed. Under the old methodology, it would have suggested 34% were under water.) As staggering as this statistic is, it pales in comparison with conditions in certain parts of the country. In Nevada, where the situation is worst, 65% of homeowners with mortgages are under water and 30% of homeowners with mortgages have mortgages that are 50% bigger than the value of their house. Not so good. (*The Wall Street Journal*, November 24, 2009.)
- In December, most civilized nations in the world will descend on Copenhagen to try and hammer out a new treaty to reduce greenhouse gases and slow global warming. The last time such a gathering tried to address the issue of climate change was in Kyoto in 1997, and that agreement never gained much traction. *Forbes* predicts that whatever may be agreed in Copenhagen is also unlikely to succeed. The reason is the refusal of China to participate. Last year, China surpassed the U.S. as the world's largest producer of carbon dioxide, despite the fact that its economy is only one-third the size of that in the U.S. By 2020, China's emissions will be twice those of the U.S. China has indicated no willingness to sacrifice economic growth in order to fight global warming. (*Forbes*, November 2, 2009.)
- One of the grim realities of the deep recession that has gripped Canada and the U.S. over the last 18 months is the large number of job losses. What is even more troubling is the nature of these job losses. Most have been focused on those that have traditionally been stable and high paying – manufacturing, telecom, and print journalism, for example. The jobs that have been created are more typically lower paying and less secure. In our view the demand structure of our economies might have permanently been altered. According to recent statistics in *Business Week*, of the 130 million jobs in the U.S., only 20% pay more than \$60,000 per year. Of the balance, the average wage is \$33,000. (*Business Week*, September 7, 2009.)
- As we enter the Christmas shopping season, malls in the U.S. are burdened by vacancy rates of about 20%. A glut of stores was built in the previous era of cheap debt and rapid expansion. Even a robust cyclical expansion of retail sales is unlikely to push vacancy rates below 15%. According to a Morgan Stanley study, the issue can't easily be solved by halting new construction; there actually needs to be square footage demolished. Morgan Stanley estimates that between 250 million and 300 million square feet of retail space needs to be eliminated. That's equal to about 7.5 Central Parks, 4,774 football fields, or everything built as retail space since 2007. (*Barron's*, November 30, 2009.)



NEXUS

Portfolio Management & Financial Counsel

Nexus Investment Management Inc. provides discretionary investment management and financial counselling services to private clients, trusts, estates and foundations.

- Exceptional client service and objective advice:** tailored to the client's individual needs.
- Superior investment performance¹:** long-term record of superior after-tax returns and capital preservation.
- Disciplined investment approach:** "Growth at a Reasonable Price" philosophy, using research and patience.
- Alignment with clients' interests:** as the Firm is wholly owned by its principals, we are committed to your financial success.
- Cost-effective management:** our services are accessible directly, without the costs of branding and distribution.

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Publication Mail Agreement 40033917.

¹ A composite of Nexus accounts, managed to a balanced mandate, has earned 7.2% per annum, pre-fees for 10 years. A composite of notional returns from a weighted average of the following indices: T-Bill (5%), Bonds (35%), TSX (35%) and S&P 500 (25%) earned a return of 4.5 % over the same period.