

Bluewater Commentary

For the Quarter Ended December 31th, 2011

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This was another volatile and confusing quarter to end a volatile and confusing year. Markets in North America and Europe oscillated between conflicting influences. On the one hand, there is enthusiasm for corporate revenues in many sectors that have been exceeding expectations thus leading to record profitability. On the other hand, there is grave concern about government fiscal affairs and unsustainable debt burdens. This tug of war looks likely to continue as we move into 2012. The Eurozone crisis remains unresolved and credit conditions there seem set to deteriorate further. It is difficult to see how this region will be able to avoid a significant economic setback as they wrestle with their structural imbalances. The United States has its own fiscal issues and a very polarized political climate at the legislative level. On the monetary front, a zero interest rate policy along with high and rising government debt is distorting the credit and investment landscape.

On top of all this, and not unrelated, is the decelerating growth in the developing world. The extent of this slow down is difficult to gauge at this time but it will probably contribute to further uncertainty as we move into the New Year.

In the face of all these complicated and unpredictable issues, it is easy to see how the markets have been seized by such turbulence.

A couple of sectors that have been undergoing unfavorable business conditions during the past several quarters are financial entities and companies dependent on commodity prices. Financials have been hampered by prolonged low interest rates as well as strained credit conditions. Commodity producers have been grappling with a significant reversal of circumstances. For several years they have been buoyed by accelerating and

strong growth in developing economies which tend to be more resource intensive than developed ones. Now China, India and South America are dealing with domestic issues that call for moderation and a period of rebalancing. The full ramifications of these readjustments are still being played out.

We have had the opportunity to sit down with many management teams over the past quarter in order to try to gain more insight as to what is happening in the “real world” as opposed to what you hear from “Wall Street” and “Bay Street”. We would like to share some general comments with you from our management teams to give you a sense of what business conditions are like today.

The tone from Rick Waugh, CEO of Bank of Nova Scotia highlighted the continued highly competitive nature of banking today. He believes that they can still grow earnings in 2012, but is suggesting that single digit growth rates are more realistic than the strong double digit growth of the last couple of years. Rick Waugh continues to emphasize the strength of their diversification in emerging markets and the tremendous opportunities they are seeing today to continue to expand their footprint. He feels they can manage their costs lower if revenue softens as expected and they plan on achieving this without any massive layoffs. He feels they do not have any material direct exposures to Europe and they are in good shape from a credit perspective.

Nick Orlando, CEO of Martinrea sees automotive volumes in North America holding steady in all this turmoil. Volumes in Europe have softened a little, but they are still on plan. The company is still on track to achieving at least \$1.00 per share in earnings in 2012. Their acquisition of Honsel is progressing well and they are seeing an increase in potential business for Honsel now that they are owned by an automotive player as opposed to a private equity group. The company will continue to focus on executing on its major product launches which are just starting to ramp.

Bill Doyle, CEO of Potash Corp. expects buying interest to return to the market in the spring as inventory levels across the distribution channels are fairly lean. There has been a buyers’ strike as potash prices have not collapsed, unlike most other commodities. The buyers want lower prices and a large Russian producer and Potash are responding by taking production downtime to better align market supply with market demand.

There is reluctance from buyers of most commodities to commit to purchases as many believe that the credit crisis in Europe will continue to put downward pressure on commodity prices. Buyers remember 2008/2009 all too well and don’t want to get caught again. Whether it is the potash distributor or the cotton purchaser neither is willing to make any significant commitments in these uncertain times. Gildan has

proactively written down their cotton inventory to market prices and reduced the pricing on past sales to reflect current prices in an attempt to alleviate the overhang and reluctance of the buyers. This business decision, although costly in the near term, is expected to return confidence to the market and should lead to improved market demand and possible market share gain for Gildan.

CAE is seeing continued strong demand for their civil simulation products and training services. Growth in emerging markets continues unabated. The order backlog in this division is strong and pricing has improved from the 2008/2009 levels. Simulation demand from the Military segment has the markets on edge as many governments are expected to cut spending to deal with out of control deficits. CAE has already booked over 80 percent of the orders required to deliver revenue growth in 2012. Although growth in military simulation is expected to slow, it will still be positive and, they note that simulation training allows the government to achieve up to 90% cost savings relative to live training. This should mitigate the impact of defense budget cuts as an increasing share goes to the more efficient simulation portion.

The general tone from many management teams was that although they do not see a significant deterioration in end demand, everyone is remaining cautious and many are choosing to work down inventory rather than ordering to sustain current business demand. If demand continues to hold there should be a respectable recovery as replenishment of inventory will be necessary to support the ongoing sales trends.

During the quarter we added a few new positions to the portfolio; Amphenol Corp., Edwards Lifesciences, Sigma Aldrich and Telus Corp.

Amphenol Corporation is one of the world's largest designers, manufacturers and marketers of electrical, electronic and fiber optic connectors, interconnect systems and coaxial and high-speed specialty cable. Connectors, which when attached to an electronic or fibre optic cable, a printed circuit board or other device, facilitate electronic or fibre optic transmission. Amphenol is the second largest player in the \$44 billion connector market, which is highly fragmented. The company has an impressive track record having consistently outgrown the market, generating solid free cash flow, achieving strong returns on capital and equity, and significantly outperforming its peers from a margin perspective through the downturn in 2008/09. We expect connectors to outgrow GDP due to the proliferation of electronics in a variety of end markets and increasing connector content in electronic products in general.

Edwards Lifesciences is a 50 year old company that became independent in 2000 when it was spun out from Baxter International as a corporate distribution. Since then the company has focused vigorously on heart valve development and is now the global

leader in this field as well as in critical care monitoring. Edwards has a presence in over 100 countries and 7000 employees.

Edwards is currently on the threshold of the most exciting stage in its corporate history. Approval by the U.S. Food and Drug Administration has been received in November of 2011 for the Sapien minimally invasive heart valve which will revolutionize treatment of faulty heart valves. This product has been employed for 3 years in Europe under CE Mark approval and has enjoyed tremendous acceptance by the heart medicine community based on very positive patient experiences. Evidence points to this becoming a blockbuster medical device allowing many more patients to obtain the benefits of valve replacement at a lower overall cost to the medical system. Recovery time in hospital is dramatically reduced from weeks for traditional open heart surgery to days with the minimally invasive device and the patient does not need to suffer the trauma of the open heart procedure.

Edwards has been carrying a heavy Research and Development expenditure burden while evolving the Sapien technology. R & D will continue to be a large commitment as the company pushes the envelope to stay well ahead of competition, but at least now they will have a growing and eventually substantial revenue stream to offset the overhead.

Secondary to heart valves, but with excellent prospects in its own right, is the Critical Care business which Edwards has developed over 40 years since the introduction of the Swan-Ganz catheter. This line of activity is being extended with the recent innovation of FloTrac minimally invasive hemodynamic monitoring and expanded with the current development of glucose monitoring.

From both a technological and financial point of view, we consider Edwards Lifesciences to be the most exciting company in the medical device business today.

Sigma-Aldrich develops and manufactures a variety of chemicals and equipment that are used as key components in pharmaceutical, diagnostic, and other high technology manufacturing. With a portfolio of over 147,000 chemical products and 40,000 equipment products, SIAL has successfully penetrated over 160 countries with operations in 39 of them. What is of particular importance is Sigma's exposure to the emerging markets, which continues to grow at more than double the rate of developed markets and plays a large role in the growth of the company.

Sigma's key end markets including hospitals, university/government research facilities, pharmaceuticals and industrial companies are well diversified and mitigate industry specific risks such as the uncertainty in government research funding. Furthermore, as

the product mix is skewed towards consumables (low price, high purchase frequency) over instrumentation (high price, low purchase frequency), the top line exhibits less volatility even in these budget constrained times.

A pivotal attribute of Sigma has been its strong track record of profitability and cash flow generation. It currently realizes margins in the top quartile of its peer group with ample room for expansion driven by e-commerce proliferation, effective cost management and supply chain rationalization. It had successfully navigated through the financial crises, exhibiting positive organic growth and expanding margins even in 2009.

Telus Corporation is the largest telecommunications company in western Canada, second largest in Canada. The company provides a full range of communication products and services through two business segments: Telus Communications, an incumbent local exchange carrier in Western Canada and Eastern Quebec, and Telus Mobility, a national wireless provider with approximately 7 million subscribers.

Telus was the first to introduce IPTV (internet protocol TV) in Canada. They have been very successful attracting new subscribers to this service, and more importantly, this has aided them to provide a more compelling bundle of voice/internet/video services to enhance customer retention. They are near the tipping point where the heavy investment phase of this rollout swings to positive cash flow.

Our reluctance to own Telus was the uncertain competitive landscape. Telus' quadruple play consisting of home phone, cellular, internet and now IPTV has given them a strong competitive offering when competing with Shaw Communications. Shaw has been pursuing a wireless strategy for some time but recently pronounced that they will not pursue a full blown wireless strategy at this time. Instead they will focus their efforts on a Wi-Fi rollout. This to us is a very weak competitive offering which we believe will allow Telus to continue to gain ground in the West against their largest rival.

In addition, we had been concerned that as other carriers vertically integrate into content, any exclusivity rights allowed by the government on this issue could hurt Telus' competitive position. With guidelines clearly trying to prevent content favoritism, we feel that Telus can continue to prosper in the cable/telecom competition. Telus has very high levels of free cash flow and is guiding for dividend increases of 10% per annum.

With 2011 having proved to be a disappointing and confusing year for stock market participants and with the same financial and political issues still hanging over our heads, it is tempting to be overwhelmed by bearish feelings. History, however, shows that these times of negative sentiment offer the best long term investment opportunities. During the last comparable episode during the 1966 to 1982 time frame when markets

remained flat over 15 years (the current secular bear is at 12 and counting), the best buying opportunity occurred near the midpoint in 1974. That represented the beginning of a 25 year bull market that culminated in 1999. The second best buying opportunity occurred about 3 years later. The market had recovered to near the highs reached pre-1974 and then corrected 25%.

Drawing parallels with the current situation, March of 2009 would look similar to 1974. The current correction which began last summer would look like the same sort of opportunity as 1977. If it is similar, it will likely have further to go on the downside and it must be remembered that it took 5 years after 1977 until new highs were finally achieved in 1982. Whatever happens with the market, all stocks do not reach bottom on the same day. We have no doubt that the current negative sentiment is offering tremendous buying conditions for many businesses. We also have no doubt that patience and fortitude will be required through an ongoing period of market volatility.

As usual, we are being very selective about the businesses we own and conservative with our valuation assumptions. It is easy to make timing mistakes in such turbulent market conditions as we are experiencing but, if we can choose the right companies, patience will be rewarded.

The Bluewater Team