

Fixed Income Update

January 18, 2011

Our Approach to Fixed Income

We apply the same investment approach to fixed-income investments as we do to equity investments. We are long-term investors in businesses. We view a stock as an ownership interest in a high-quality business and we endeavour to acquire these ownership stakes at prices below our assessment of their true worth. As it relates to fixed-income investments, we endeavour to buy securities that provide us with an attractive return through coupon payments and capital appreciation while focusing on the borrower's (or bond issuer's) ability to meet its debt obligations – the payment of periodic coupons and the return of the original principal at maturity.

The Current Environment

Fixed-income investments have been extremely popular for the last two years due to their “perceived safety”.

As we look forward to 2011, there are several signs that concern us:

- High-yield bond prices are at historically high levels as shown in chart 1. Investment-grade and high-yield credit spreads could continue to tighten but the significant moves have already occurred (see chart 2 and 4).
- After 99 straight weeks of inflows (as at Nov. 17, 2010), bond funds have suffered from several weeks of net redemptions. The week ending Dec. 15, 2010 showed the largest amount of outflows since November 2008 – a time when investors were liquidating their positions due to the credit crisis (see chart 3). Will an outflow from bond funds affect prices in the bond market?
- We do not feel credit spreads for certain sovereign debt, investment grade and high-yield issuers are representative of the associated credit risk
- Many companies are taking advantage of all-time low yields to refinance existing debt and extend maturities. These longer-dated bonds pose greater interest rate risk.
- Bond agreements are becoming less restrictive for borrowers with looser capital allocation policies, enabling them to take on greater amounts of leverage
- Recent high-yield new issuances have increased by approximately 2% - 4% in price on the first day of trading - historically, a sign of greed, rather than fear
- Absolute yield levels on investment-grade new issuances are at all-time lows (i.e. Walmart, IBM, McDonald's)
- The issuance of 100-year bonds

Chart 1

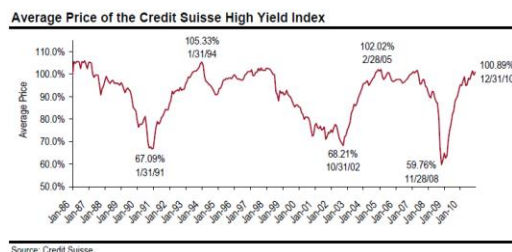


Chart 2

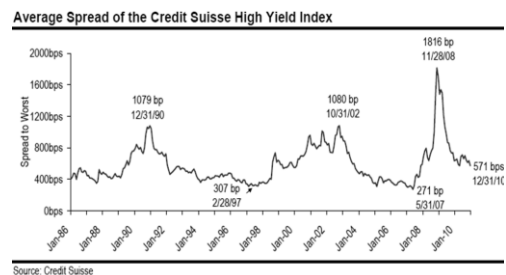


Chart 3

Are Bond Prices Correlated to fund flows?
A 99-week streak comes to an end in December 2010

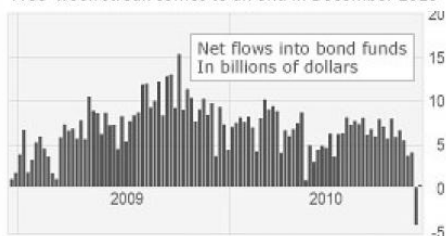


Chart 4



Source: Credit Suisse, BMO Capital Markets, TrimTabs Investment Research

We believe the above points are indicative of investors focusing on return potential, with less regard for risk. Our number one priority at EdgePoint is the preservation of capital by focusing first on the inherent risk of an investment and then analyzing the potential return.

How Are We Reacting?

While we cannot predict what will happen to interest rates or credit spreads in the future, we strive to protect our investors from potential risks.

- We have shortened our fixed-income duration in order to protect the portfolio from the risk of rising interest rates. We currently have half of the interest rate risk of the DEX Universe Bond Index – an index that tracks the broad Canadian bond market. The duration of EdgePoint’s balanced portfolios is approximately 3.0, while the index has a duration of 6.15 years.
- We remain 100% invested in corporate bonds. We have invested selectively in this sector, finding corporate bonds offering relatively attractive yields.
- We have increased our cash levels. Investment returns are driven by the purchase price of a security. After this year’s significant price increases, we are finding fewer opportunities. We are comfortable holding cash when we can’t find compelling alternatives.

Our High Yield Exposure

The volatility in the equity markets is providing us with a number of opportunities to purchase securities which offer attractive yields and whose underlying businesses are strong. We leverage our equity analysis in order to find high-yield opportunities. In fact, we own the equity securities of 30% of our fixed-income issuers.

Examples:

Videotron: Quebec's largest cable company.

Videotron recently launched a wireless network. We feel its superior service and proprietary content will help the company gain market share from the incumbents.

Corus: Owns specialty television channels and content with a focus on the women and children demographic.

Corus has a very strong balance sheet with strong free-cash flow generation.

Interpublic: Global marketing and advertising service company

Interpublic has strong free cash flow with net cash on the balance sheet.

Convertible bonds

These investments are compelling as they provide us with an attractive yield and the opportunity to participate in equity appreciation.

The Trend Towards Re-Financing

Many companies are taking advantage of historically low interest rates in order to re-finance their debt with longer-dated bonds. We are cautious not to chase the higher yields offered on these re-financing issues. Several of our fixed-income holdings announced such offers, however we did not participate in any of these re-financings. Although we believe the underlying businesses are attractive, we didn't feel that the yields compensated us for the increased interest rate risk of a longer-dated maturity issue.

Examples:

Calfrac Well Services Ltd.

We were quite optimistic about the future of Calfrac and owned both their debt and equity securities throughout most of 2010. We participated in a re-opening of their 7.75% debt issue in December 2009 at a purchase price of \$94.50. Due to favourable credit market conditions, the company decided to refinance this debt and extend the maturity. They repurchased their bonds from us at over \$105.50 just one year later, resulting in a holding period return of approximately 20%. Although we still felt strongly about the prospects of Calfrac's underlying business, we did not participate in the re-financing as we didn't believe the yield properly compensated for the additional duration risk.

Interface Inc.

Interface issued debt in mid 2009 when investor fears were high. We purchased the 11.375% issue maturing in 2013 at approximately \$96.50. Like Calfrac, Interface chose to refinance this debt issue and extend its maturity. We tendered our bonds for purchase at a price of \$123, locking in a holding period return of over 40%. While we are confident in Interface's ability to service its debt obligations, we did not want to incur the additional interest rate risk of a longer-dated issue.

We continue to find attractive fixed-income opportunities but we are acutely aware of the risks that today's market environment is presenting. We will continue to search for mis-priced fixed-income securities, taking a long-term approach and exercising patience with your capital.

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