



Trimark Perspective: Volume 3

The U.S. Debt Downgrade and Market Volatility

Market volatility has dramatically increased in recent weeks with fears that a sovereign debt crisis will spiral out of control and throw the world economy back into recession. The recent credit rating downgrade of the United States has only heightened investors' angst. The Trimark discipline does not adhere to top-down analysis, rather it focuses on company fundamentals and the economics of the underlying business. However, with equity markets selling off and stock prices declining indiscriminately, Trimark portfolio managers **Ian Hardacre, Dana Love, Erin Greenfield, Virginia Au, Darren McKiernan, Don Simpson and Rory Ronan** provide their perspectives on these events, how they are responding to these challenges as portfolio managers, and their views on how long-term investors should approach today's market environment.

"We will continue to ignore political and economic forecasts, which are an expensive distraction for many investors and businessmen... Imagine the cost to us, if we had let a fear of unknowns cause us to defer or alter the deployment of capital. Indeed, we have usually made our best purchases when apprehensions about some macro event were at a peak. Fear is the foe of the faddist, but the friend of the fundamentalist." ~ Warren Buffett: 1994 Berkshire Hathaway Annual Report

Are you finding opportunities due to the increased volatility?

Hardacre: We certainly feel for those who have been negatively impacted by recent market events. Although times like these can be trying for some, we see them as buying opportunities, as they provide us with prospects that the market normally does not afford. For many, fear and short-term performance often drive investment decisions. Individuals and institutions alike are forced to sell, often at any price, to make margin calls or to abide by some poorly constructed investment mandate rule. It is our job to be prepared and make the changes in the portfolio that improve its risk/return profile.

In a perfect world you would enter these periods with abundant cash. This is the case for Trimark Canadian Endeavour Fund that Clayton Zacharias and Mark Uptigrove manage. This is not the case with the Funds I run, such as Trimark Canadian Fund and Trimark Select Balanced Fund, as both Funds tend to be fully invested.

We have been repositioning the portfolio to make the most of the better risk/return situations over the past few weeks. Often this requires selling what is going up (or not moving) to take advantage of what is falling. As a result, we have been selling our gold stocks and consumer staple companies that have been going up or staying flat to fund purchases in beaten-down companies. This strategy proved very successful in previous volatile times, including the 2008/09 period. It should be noted that it may cause some short-term underperformance as most of our competitors will be doing the opposite.

Love: We entered the current turbulence with a healthy cash position of about 10% within Trimark Fund. Given the opportunities we're seeing at present, we are selectively deploying that cash daily. There are a number of investment ideas and companies on our wish list that have either already reached our price points or are very quickly approaching valuations that we would find attractive, giving us the incentive to make some purchases.



Ian Hardacre

Trimark Select Balanced Fund,
Trimark Canadian Fund, Trimark
Canadian Class, Trimark North
American Endeavour Class,
Invesco Core Canadian Equity
Class

Industry experience: 19 years

It is always difficult to know when and where the market dislocations will end. That is why, as patient investors, we focus on the long-term intrinsic value of the individual businesses we're interested in. That said, we rarely ever pick the absolute bottom in a declining market. We act as long as the margin of safety and the intrinsic value is compelling enough for us to do so.

Greenfield: Despite the recent market turbulence, Jeff Hyrich and I have not been buying any new businesses or selling any of our existing holdings in Trimark Global Endeavour Fund or Trimark Global Balanced Fund. We are very comfortable with the holdings in both portfolios. We own high-quality companies that have good balance sheets, growth prospects and management teams, and that are trading at reasonable valuations.

Au: Trimark U.S. Small Companies Class started the second quarter of 2011 with 9.3% in cash. By July 31, we were sitting on 17.4% cash. It would be easy for us to boast about our ability to foresee a major financial market meltdown in August, but as experienced investors know, the track record for accurately predicting financial market movements is typically poor. The truth is, our decision to increase our cash weighting was guided by our bottom-up investment philosophy. Prior to August, we had been slow in adding new holdings because we did not see adequate protection for the risk. In general, small-cap companies' earnings estimates outpaced their fundamentals. For example, the small-cap Russell 2000 Index was trading at 22 times consensus P/E on very optimistic earnings and near-peak margins. Now that the Russell 2000 Index has dropped 15% in the first 10 days of August, stocks are just beginning to discount a more realistic, sluggish recovery.

McKiernan: We are seeing market opportunities across the board, but are closer to buying some businesses over others based on price and quality (i.e., we're always going to be more selective when it comes to the more cyclical businesses). For instance, we have reduced the cash from the mid-teens to less than 9% within Trimark Global Dividend Class. We're building on existing positions and have also added three new businesses. We will continue to be judicious deploying cash.

For Trimark Global Fundamental Equity Fund, we were close to being fully invested going into this correction, with less than 5% cash. We have added to our Asian and emerging market holdings during the recent downdraft, and have been selectively buying and/or upgrading some of our U.S. holdings.

While no one likes a bear market, Trimark Global Fundamental Equity Fund has held up relatively well over the past three months (12th percentile for the three months ending Aug 9th). We had been fairly defensive heading into this downturn as less than 3% of the Fund is invested in banks, it is under-represented in commodities and basic materials, and holds lots of health care and consumer staples. As a team (including Jeff Feng, Michael Hatcher and Dana Love), we still like our portfolio of businesses. By and large, these are leading franchises, often with a global footprint (or a dominant local one) that generate high returns on invested capital and ample free cash flows. There is very little true balance sheet risk in the Fund. Our "dream team" (i.e., companies we want to own but don't due to their inflated prices) is being monitored very closely, and we will not hesitate to upgrade the portfolio as opportunities come our way due to market dislocation.

Hardacre: It is always impossible to determine how long periods of volatility like this will last. What I do know is it *will* end. More than likely we will look back at this period as an opportunity given to us by "Mr. Market" to buy high-quality companies on the cheap.

Simpson: Yes we are. Valuations are getting more attractive across the board, rather than in isolated, out-of-favour sectors, as we saw earlier in 2011. While this volatility justifiably rattles investors, we strongly recommend investors stay the course with their investments, and focus on their long-term objectives. To abandon equity markets until the sovereign debt situation is resolved is, we believe, a grave mistake. In government bonds, yields are very low and likely negative after inflation, while in equities, we see



Darren McKiernan
Trimark Fund, Trimark Global Dividend Class, Trimark International Companies Fund, Trimark Global Fundamental Equity Fund, Trimark Global Fundamental Equity Class, Trimark International Companies Class, Invesco Core Global Equity Class
Industry experience: 15 years



Don Simpson
Trimark Diversified Income Class, Trimark Diversified Yield Class, Trimark Income Growth Fund, Trimark Canadian Plus Dividend Class, Invesco Core Canadian Balanced Class
Industry experience: 16 years

strong franchise companies trading at high single-digit earnings yields or even double-digit free-cash-flow yields.

Can you comment on how the current macro issues are impacting the Funds?



Erin Greenfield
Trimark Global Balanced Fund, Trimark Global Balanced Class, Trimark Global Endeavour Fund, Trimark Global Endeavour Class
Industry experience: 13 years

Greenfield: Government balance sheets and deficits are clearly a mess in the U.S. and in Europe. Jeff and I tend to focus on companies that are more global in nature. We have businesses in the Trimark Global Endeavour Fund and Trimark Global Balanced Fund with operations in Latin America, Asia, Africa, Eastern Europe and The Middle East. This adds diversification, plus some of the governments in the emerging market regions are in better fiscal situations than the U.S. or several of the more problematic Western European nations. Additionally, we prefer companies with above-average balance sheets that should be better able to fund themselves in the event of credit market turmoil and that have a lower risk of default should their earnings deteriorate due to a weaker economy.

Heavily leveraged companies are most exposed to problems in the credit markets. Financials, banks in particular, fit this definition. We currently do not own any banks and we have limited exposure to other financials. Our financial holdings – WellPoint Inc., Tullet Prebon PLC and Vienna Insurance Group – each proved during 2008's financial crisis that they are well-capitalized, well-funded, profitable and able to withstand credit market turmoil.

Au: Within Trimark U.S. Small Companies Class, the Small-Cap team has been cautiously deploying cash in stocks that have been hit particularly hard but continue to have strong secular growth. For example, we have increased our weighting in performance material and specialty chemical manufacturer, Solutia Inc. On the surface, Solutia appears to be a cyclical company driven by construction and new auto production; hence, the stock dropped disproportionately in recent days. In reality, 35% of its revenue is from tire and windshield replacement and an additional 12% comes from energy-efficiency products. Furthermore, Solutia has a global footprint with only a quarter of its revenue from the United States. Trading at 6.5 times 2011 EV/EBITDA, this company is the proverbial "baby being thrown out with the bathwater." As the markets oscillate, we will continue to look for quality companies with attractive risk/return profiles.



Virginia Au
Trimark Canadian Small Companies Fund, Trimark U.S. Small Companies Class, Trimark Global Small Companies Class
Industry experience: 7 years

Love: Markets are prone to overreaction, overshooting and both excessive optimism and pessimism. Arguably, earlier this year the general price level of the market had overshot to the upside, with very little margin of safety and excessive optimism over the sustainability of the level of economic growth and the profit cycle. That situation is now correcting itself. None of this should surprise anybody given the very real systemic and sovereign risks facing much of the developed world, which had become overleveraged as the burden of private debt was transferred to the public sector.

The good news is that this situation, where selling and sentiment becomes indiscriminate, presents an ideal environment to take advantage of buying some great business franchises at very attractive prices. In the last week we have added a few new businesses to Trimark Fund, and have been able to increase our weighting in some of the businesses we already owned. We have made purchases in Brazil, China, Hong Kong, Singapore, the U.S., Europe – even Canada.

Hardacre: The U.S. and Europe have mismanaged their finances, and they continue to look for a short-term solution to a long-term problem. Inevitably, I believe governments will come to the realization that when you have too much debt and not enough revenue, your choices are severely limited. Eventually it will mean higher taxes and less spending, which will be negative for markets worldwide. This is the reality that's sinking in.

Such is the world we live in; it's uncontrollable. What is controllable is how we, as portfolio managers, deal with the situation. In times like these the common instinct is to run for safety and buy what I call "feel good" stocks – stocks which allow you to sleep at night – or to buy what the media is touting, such as gold stocks. We believe this is the wrong action to take. Another common mistake is to do nothing. Undeniably, the recent market downturn has provided a better risk/return situation for many stocks than what existed just two months earlier. We are using this correction to upgrade the portfolio.



Rory Ronan

Trimark Diversified Income Class, Trimark Income Growth Fund, Trimark Canadian Plus Dividend Class, Trimark Diversified Yield Class, Invesco Core Canadian Balanced Class
Industry experience: 16 years

Ronan: From a macroeconomic perspective, we expect the global economy will grow at a slow but positive rate. That said, our portfolios (Trimark Income Growth Fund, Trimark Diversified Class and Trimark Canadian Plus Dividend Class) are not guided by our top-down views. We do not rotate into defensive sectors when economic conditions are poor. Doing that is to treat investing like a game of musical chairs where you're trying to anticipate what other investors will do before they do it.

Furthermore, for this strategy to pay off, you have to be correct twice since you have to guess when to get out as well as in. A few portfolio management teams at other investment firms have been successful with a top-down approach, but this is not what we do.

Our approach is to own companies with strong balance sheets, low debt, strong cash-flow generation, and sustainable competitive advantages that should outperform their peers over a long holding period of three to five years or more.

We invest in those companies when, in our view, they are trading at a discount to their intrinsic values. We also strive to be well-diversified at all times, and an analysis of both risk and reward drives all our investment decisions. We do own cyclical names; however, this is not so much a market call as it is part of our effort to better diversify our portfolio opportunistically when valuations are attractive.

What are your thoughts on the U.S. credit downgrade?

Greenfield: The U.S. government is still AA+ (and AAA according to Moody's and Fitch), and they have the power to move back to AAA if they get serious about improving their fiscal situation. The U.S. is a very diverse and wealthy economy, with a strong entrepreneurial spirit and good corporate governance. What's more, it's a democratic society governed by the rule of law. So we would caution investors not to overplay the current uncertainties. We believe the U.S. will remain an attractive place to invest over the long term.



Dana Love

Trimark Fund, Trimark Global Fundamental Equity Fund, Trimark Global Fundamental Equity Fund /Class, Trimark Europlus Fund
Industry experience: 17 years

It's important to remember that equity markets have always been very volatile, and this will likely always be the case. However, this does not mean equities should be avoided. On the contrary, equity markets have historically provided superior opportunities to build wealth over the long term, and bear markets can create compelling opportunities for investors with a long-term perspective to benefit from the bargain prices in the market.

Love: In terms of the potential economic impact, the U.S. downgrade is both symbolic and real. When a country's debt is downgraded it is expected that there will be a rise in the cost of funding for that nation. Since the "risk-free" rate is the base rate most investors use to determine the cost of capital for *all* investments, in theory a downgraded debt rating will increase the cost of capital at all levels of decision making (corporate projects, investor discount rate and opportunity cost of capital, etc.), even if the adjustment is not immediate.

However, in this particular case the symbolic nature of the downgrade is probably the more important of the two consequences in the short-term as it is the first time in history that this has happened to the U.S. The downgrade can be construed as a signal that the

U.S. is losing its influence globally and that it is increasingly a “riskier” place in which to invest. The AA+ rating is still a very respectable and high credit rating. Nevertheless, the downgrade is an indication of change, one that is undeniably negative.

Within a global context, the U.S. is likely to remain a low-risk and highly rated country. Still, the downgrade is symbolic of the deterioration in its global stature on a number of levels. These include its ability to service its debt, its future liabilities and entitlements, and, most important given S&P’s rationale for the downgrade, its political stability and its willingness to getting serious about addressing its future funding requirements.

McKiernan: The market is still trying to figure out the impact of the U.S. downgrade, as this has never happened before. In theory, S&P is saying the U.S. dollar and economy are in worse shape today than they were last month, yet we have seen a massive rally in the U.S. dollar and a decline in Treasury yields over that time period as capital flees to the relative safety of the United States. And while the US can always print money to pay its debts, longer term such “debt devaluation” is likely to have negative consequences for the dollar and pose an inflation risk for the US consumer. Regardless, our job is to identify companies that can best adjust to whatever the outcome from the downgrade ultimately is.

Au: While the U.S. downgrade by S&P ignited a dramatic market sell-off, the larger issues are the lack of coordination from policymakers for the European debt crisis and the stubbornly high unemployment rate in the United States. While these problems require long-term solutions, many stocks are becoming increasingly attractive as they start to reflect these risks.

***Trimark Perspective* brings you the opinions of the Trimark Investment team on topical issues that impact businesses around the world and carry implications for long-term investing. Trimark managers regularly travel the globe, uncovering investment opportunities in high-quality, well-managed companies that have a strong and sustainable competitive advantage. These opportunities often present themselves when short-term market uncertainties reduce share prices to levels that provide a margin of safety for investors seeking to protect and grow their capital over the long term. Trimark managers firmly believe their long-term investment approach is a significant advantage in a market that is predominantly short-term in focus.**

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