YORKVILLE PERSPECTIVE

Managing risk, nurturing wealth.
YORKVILLE ASSET MANAGEMENT INC

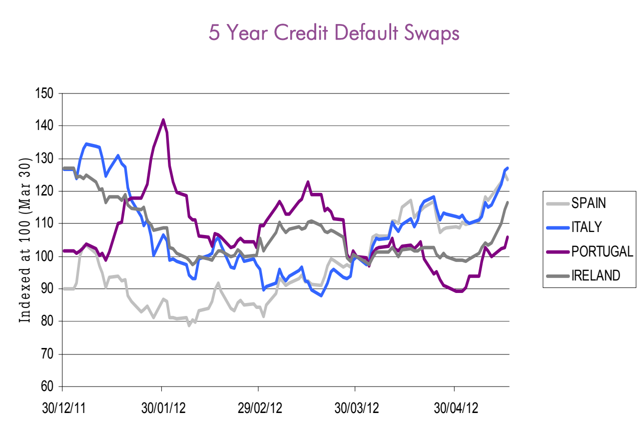
MAY 2012

HERE WE GO AGAIN… AGAIN?

A SLOW MOVING TRAINWRECK

With the wind at the back of equity markets for the first quarter of 2012, it appears once again that macro headwinds are poised to setback equity markets as the European debt crisis takes centre stage. While this may sound somewhat like a broken record, we expect that tug-of-war between strong corporate earnings and unmanageable sovereign debt loads will continue for an unforeseen amount of time. What may be more troubling, however, is the fact that governments and central banks are running out of rabbit-in-the-hat tricks to spark another rally in the financial markets.

Prior to writing this piece, the ECB and IMF were willing to trade bailouts for austerity, with the markets applauding the acceptance of austerity. However, while the markets may view this as a positive, the true victims of austerity, those living in Greece, Italy and Spain, are not feeling the same benefits of the markets, they are only feeling more severe financial pain and hardship. The elected leaders who were pressured into accepting austerity for cash are now being ousted from their Government with the populous demanding growth from their government.



Take Greece as the prime example – This country is no longer motivated to promote the financial stability of the ECB, it needs to stabilize itself before it can worry about its neighbours which have isolated Greece anyway. And so here we are today, in the midst of the worlds slowest moving train wreck, more commonly referred to as the maintenance of the European Union, and to borrow a line from NBC's prime time hit, The Biggest Loser – Europe, and hence, the rest of the world, will "have to lose to win".

WHAT DOES THIS MEAN?

We will have to face a period of contraction and consolidation. The strong will take over the weak, the fragile financial sector will continue to consolidate and restructure. Band-aid solutions and kicking-the-can down the road policies, while appreciated from the get-go, will certainly come to roost and investors should be positioned accordingly.

Thankfully, as Europe and Emerging Markets contract, Canada and the US continue to show relatively favourable numbers.

This year has so far progressed as expected. The U.S. recessionary conditions are starting to ease albeit at a very slow recovery pace. In some states, the recovery is considered healthy but remains anaemic in key crucial states.

Canadian markets have so far been sheltered from global developments. However, our resource based economy that thrives on exports and is backed by a strong banking sector might take a turn for the worse much sooner than expected. This does not put the Canadian economy at par with severely distressed markets, but nevertheless, we see a contraction in the overextended real estate sector, a reduction in bank loans and a material pull back in resource based equity prices.

In our Client Conference Call held in February 2011, we highlighted the risks of investing in China. At that time, we expressed our primary concern over what we referred to as a "*looming banking crisis*". We are still avoiding major exposure to the Chinese markets and are waiting for the full transition of government in 2013 before we can properly articulate a long term view regarding any investment in such a highly controlled market.

STRATEGY HIGHLIGHTS

With that being said, Yorkville's equity performance was very strong in the first quarter of 2011, outperforming its benchmark by a significant margin. But going into the summer months, as European credit spreads are percolating once again, we are tactically shifting our positioning to be more defensive, maintaining higher cash levels in the portfolios, underweighting cyclical and overweighting defensive sectors, and stepping up our options hedging program with increased activity in covered call writing and protective put buying.

In our 2012 Spring Investment Forecast, we said that U.S. equity markets will continue to outpace all other markets in both Canadian and U.S. dollar terms. As of today, U.S. markets along with the Hang Seng and German DAX are the only equity markets that have positive Year to Date (YTD) returns. This portfolio positioning has provided our portfolios a material alpha in 2012 (as it did in 2011).

YTD RETURNS*

	CAD	USD
As of May 18, 2012		
Dow Jones Industrial Average	2.76%	2.37%
NASDAQ	7.55%	7.14%
S&P 500	4.26%	3.86%
S&P/TSX	-4.71%	-5.07%
Euro Stoxx	-5.93%	-6.29%
NIKKEI	0.33%	-0.05%
Hong Kong Hang Seng	4.05%	3.65%
Deutsche Borse AG German Stock Index DAX	4.84%	4.44%

**Source: Bloomberg*

Now, with all that being said, we are not gloom-and-doom believers. And as our Equity Portfolio Manager, Paget Warner, continues to remind clients that this is and will continue to be a market for stocks, but not the stock market, we continue to actively seek investment opportunities. As the markets sell-off indiscriminately from the macro headwinds, fundamentally undervalued companies with strong balance sheets, sound business models, and predictable earnings, will undoubtedly sell off as well. These companies remain profitable amidst the chaos and some even maintain their growth. These are the companies we want to be invested in for the very long term.

YORKVILLE STRATEGY - SPECIFICS

We maintain with our belief that this trend will continue well into the year but will be interrupted with a few profit taking sell offs that could bring the markets lower as the year progresses. Nevertheless, with this year being a U.S. election year, we will have the catalyst that is needed to keep the current pace of U.S. stocks intact. Since the beginning of 2012, all classes of our fund have had a material overweight to U.S. equities (65% U.S., 35% Canadian), and we are even reducing our Canadian exposure further to 30% in favour of Cash & Cash Equivalents.

We continued to increase our covered call activities since the beginning of the year. We currently have a 40% coverage ration, the highest we have had since launching our fund. Writing these covered calls provides us with a cushion against modest declines in equity values we want to be invested in for the very long term.

We are also executing a risk mitigation strategy for more severe volatilities before we enter the summer months. We have calculated our hedge ratio (insurance protection) on all of our equity funds, and we are currently doing an analysis to see if it is more appealing to pay for insurance during the summer months rather than attempting to chase volatility in what is known to be a traditionally weaker trading months.

In the fixed income space, we have reduced our duration in favour of additional credit exposure. The significant manipulation of this market by central banks makes it more difficult to forecast an interest rate (yield curve) path as politics seems to trump sound economic policies, leaving traditional forecast methods ineffective.

In the current market, our preferences for asset type and market are as follows:

LIKE	DISLIKE	NEUTRAL
U.S. Equities	Canadian Equities	U.K. Equities
U.S. Corporate Debt	European Equities	
	China & Emerging Markets	

WHAT'S NEW

SOUTHBRIDGE HEALTH CARE FUND

The development of our new health care fund is nearly complete with the launch anticipated in mid to late July. The Southbridge Health Care Fund, co managed with Southbridge Capital, brings investors a steady yield based investment expertly managed by the former owners of Versa Care, Canada's largest private health care provider prior to its sale to the Reichmann's. The Health Care Fund will initially focus on investing in long term care facilities, funded by the government. The units are expected to yield 8% per annum while still providing for capital appreciation. The investment is available to accredited investor's only and further information can be found by contacting us or visiting the Fund's website at www.southbridgefunds.com.

YORKVILLE HERITAGE MUTUAL FUND CORPORATION

Yorkville Heritage Mutual Fund Classes can now be purchased through the following brokerage platforms:

Discount brokerage platforms:

- RBC Direct Investing
- TD Waterhouse Discount Brokerage
- BMO InvestorLine

Full-Service Brokerage Firms:

- BMO Nesbitt Burns
- RBC Dominion Securities

For more information on our funds, please contact Jillian Wade at jwade@yorkvilleasset.com.