Equity markets in most parts of the world posted strong performance during the first quarter of 2013, propelled by economic recovery and healthy corporate balance sheets. Markets rode the wave of rising investor confidence, which had been boosted by economic stimulus packages announced late last year in the United States, Europe and Japan. Interest rates remained low and many companies continued to report strong earnings. However, the bond market was little changed, with U.S. 10-year government bond yields moving 10 basis points higher, while Canadian yields fell six basis points.

Canada lagged other equity markets, held back by lacklustre returns in the materials and financials sectors. The S&P/TSX Composite Index rose 3.3%. The market had a more cautionary tone than in previous quarters, as defensive sectors outperformed cyclical ones. Investors, worried about the strength of the domestic housing market and high consumer debt, continued to seek diversification and better returns in foreign markets.

U.S. stocks outperformed other markets, as the S&P 500 Index reached a new high and gained 12.9% for the quarter, compared with 10.1% for the MSCI World Index (both in Canadian dollars). The U.S. economy continued to improve from post-recessionary levels, led by encouraging housing and employment statistics.

Overseas, European stocks fared well despite lingering sovereign debt issues. The big news was in Japan, where stocks advanced nearly 20%, in response to the Bank of Japan's plans for an aggressive monetary policy. However, uncertain economic growth hurt equities in China and emerging markets. China continues to face challenges transforming its economy from one based on production to one on consumption.

The Cambridge funds outperformed their benchmarks during the quarter, as we continued to favour non-cyclical sectors over commodity-based ones, U.S. stocks over Canadian and in our income-oriented portfolios, equities over bonds.

Our Canadian portfolio was generally overweight consumer staples, information technology, industrials and health care. We increased positions in natural gas-related stocks, as a colder winter improved prospects for producers due to a higher commodity price, and maintained positions in refiners and service/infrastructure providers. We added Canelson Drilling, Delek, Kelt Exploration and Seacor to the portfolio, and maintained large positions in Artek, Tourmaline Oil and Perpetual Energy.

The winter weather also prompted a reduction in holdings of retail and transportation stocks, including Canadian National Railways, Transforce, Metro and PetSmart. Alimentation Couche-Tard, George
Market Commentary

Weston, Loblaw and Shoppers Drug Mart remained key investments. Overall, we took profits in a number of sectors, and the portfolios' cash positions were in the 20% range at the end of the period. Early in the second quarter, we began buying stocks as valuations became more favourable.

Our U.S. portfolio benefited from overweight positions in the industrials and health care sectors. Energy, consumer discretionary and financial holdings and also made large contributions to performance, despite our underweight positions in these sectors. Our U.S. market strategy focused on the recovering U.S. housing market, particularly in construction-related areas. We maintained our long-term interest in the aerospace industry. A major new investment was Trinity Industries, a railcar and barge manufacturer and construction company. We also added construction equipment manufacturer Caterpillar. Other important holdings related to the construction recovery were UTD Rentals and Deere.

In aerospace, our key holdings were Alaska Airgroup, Triumph and Teledyne. In information technology, we sold off Apple and added Autodesk and Micron. IBM, Google, Akamai and Vmware remained major holdings in this sector. We added Illumina to our health care position, and took profits from some of our other large positions, including Community Health Systems, HCA Holdings and Merck. Gilead was our biggest holding in this sector.

The major change in our international investing strategy was the addition of many Japanese stocks across various sectors. Cambridge Global Equity outperformed due in part to overweight positions in industrials, health care and consumer discretionary, and underweight positions in materials and consumer staples. Despite being overweight, our position in financials also made a large contribution.

Our Japan position stood at 10% at the end of the period, after being completely out of this market in previous quarters. Our holdings were not only in export areas (the traditionally favoured investment avenue in Japan) but in domestic-focused companies. The biggest Japanese acquisitions were Sawai Pharmaceuticals in health care and Central Japan Railway and Yamato Transport in industrials. We made investments in the consumer sector, including Kirin Brewery, Pigeon, Uni-Charm, United Arrows and Notori.

We had a large position in health care, investing in a wide ranges of areas from pharma to equipment and care delivery. Key holdings in addition to Sawai were Roche, Novo-Nordisk, Merck and Abbott Labs. We took some profits from HCA Holdings, Coloplast and Novo.

Our income portfolios were about three-quarters in equities, as we continued to find better yields in dividend-paying stocks, as well as growth opportunities, than in the bond market. In addition to our high equity weighting, holdings in the financials and energy sectors made the biggest contribution to performance. Our focus will continue to be higher-quality, consistent dividend-paying companies that can provide us with an attractive dividend yield, growth in dividends, and potential for capital appreciation from steady earnings growth. However, our goal is to eventually bring the equity portion closer to the target levels of 60% in Cambridge Canadian Asset Allocation, and 50% in the Cambridge Income and Cambridge High Income funds.
Market Commentary

Continued efforts by central bankers around the world to stimulate economic growth should sustain equity markets in North America and Europe. However, we anticipate European economic growth will remain strained due to fiscal austerity measures. Interest rates around the world remain severely depressed as a result of central bank intervention designed to drive rates lower. Ultimately, this should sustain growth or lead to higher levels of inflation; either of which would signal the end to declining rates.

Given the low level of interest rates, the resolve of the U.S. Federal Reserve to restore employment and the strength of the financial health of corporations, we would expect a repeat of the pattern of seasonal slowdowns in the second and third quarters to be followed by expansion in the latter part of the year.

On both an absolute and relative basis, globally, equities appear more attractive than bonds. Should commodity prices fail to recover, we would expect Canadian stocks to continue to lag those in the U.S. and Europe. The combination of a slow but improving economy, low interest rates, improving employment and strong corporate earnings should continue to be constructive for stock prices in the United States. We continue to prefer non-cyclical sectors over commodity-based ones. Under this scenario, the U.S. market should strengthen as the U.S. recovery holds less risk than that of Europe. The Canadian dollar could weaken if a softer economy leads to lower interest rates versus the U.S. and if commodity prices remain depressed.

We have no immediate plans to invest in China, due to the unreliability of companies’ financial reporting and the challenges that country faces transforming its economy from one based on production to one on consumption. If manufacturing production continues to ease there, this will likely continue to constrain global commodity prices.

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