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*A Message from Barry McInerney*

## The Economic Three R's – Resiliency, Recession and Reaction

**The National Bureau of Economic Research recently declared** the 2007-09 economic downturn the most pronounced since the Great Depression. Yet the Great Recession will soon be defined not by the severity of its contraction but by its subsequent recovery — a stubbornly weak upturn, particularly in contrast to the rises that followed the significant post-World War II recessions of 1973-75 and 1981-82.

There continues to be abundant media coverage concerning the likelihood of a double-dip recession. Several industry studies and surveys point to a 1-in-3 chance of this occurring. This possibility raises important questions, namely:

- Could the economy demonstrate resiliency in the midst of a double-dip recession?
- Would reactions to a double-dip recession by government, the corporate sector, and even the media become the defining factors of recovery?

We don't share the view that a second dip into recession is imminent. We believe the economic recovery will continue to move forward at a slow and measured pace.

The global economy is restructuring at an ever increasing rate. As a result, each recession introduces a "new normal," the set of conditions that characterize periods of growth and recovery in the business cycle. Increasingly, a normal recovery takes longer to unfold in developed countries and results in lengthening periods of high unemployment. In the United States, traditional post-recession growth engines of consumption and housing have been restrained. That's at least partially due to the demographic realities of an aging population that may now value the

peace of mind created by higher savings balances over the rapid gratification that accompanies the purchases of consumer goods, entertainment and improvements in housing. (cont. page 2.)



**Barry S. McInerney, CFA**  
President and  
Chief Executive Officer

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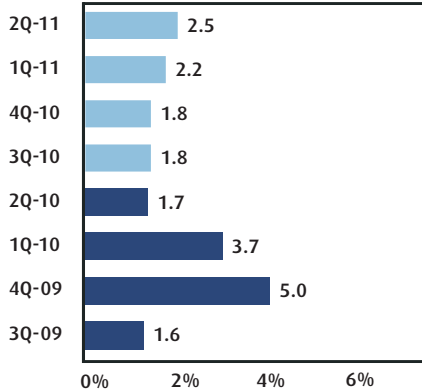
***“We believe the economic recovery will continue to move forward at a slow and measured pace.”***

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### ECONOMIC INDICATORS

#### REAL GDP

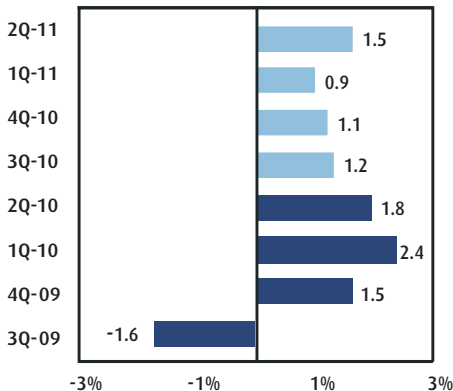
Quarter/Quarter % Change



Forecast Periods

#### CONSUMER PRICE INDEX

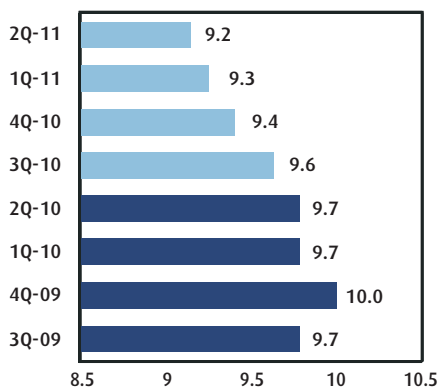
Year/Year % Change



Forecast Periods

#### UNEMPLOYMENT

Percent



Forecast Periods

## The Economic Three R's – Resiliency, Recession and Reaction (cont.)

Still, for all its plodding, the economy has shown remarkable resilience to shocks including the European debt crisis and the retrenchment of government stimulus initiatives. After a painful restructuring of work forces, U.S. companies are well positioned to compete globally on the strength of high levels of profitability, productivity, and free cash flow. Strong economic growth in the emerging markets of Southeast Asia, Latin America, and parts of Europe should fuel export growth that will increase capacity utilization in the resurgent domestic corporate sector. This, in turn, should establish enough traction to offset the malaise in housing and consumer confidence and prevent us from falling back into recession. In this environment, additional government measures need only be modest and applied with laser-like focus. Under the new normal, housing and consumption are unlikely to recover to prerecession levels, but when they do turn up in 2011 or later, we can reasonably expect economic recovery to approach a more customary growth rate, in the area of 3%.

If the economy does indeed slip back into recession, the impact will depend on the reaction from corporate and consumer sectors and, unfortunately, to some extent the media. Even slightly negative economic growth for a couple of quarters could very well suggest an economy requiring more time to restructure as it weans itself from historic levels of government intervention. If this is the case, and consumers and companies view it as such (and the media avoid the tendency to sensationalize), it will mean a slower road to an inevitable full recovery rather than a recurrence of the Great Recession.

Again, our position remains that a double-dip recession will not occur. But if it does, let's hope it is brief and modest and, most important, that everyone simply views it as part of the journey toward long-term recovery.

We appreciate your feedback on this topic and the rest of this edition, and welcome your ideas for future topics. Meanwhile, we hope you enjoy this edition of The Investor.

Sincerely,

Barry S. McInerney, CFA  
President and CEO

## Investing in Commodities for a Brave New World



**Ernesto Ramos, Ph.D**  
Managing Director,  
Research

Lines formed quickly in Beijing and Shanghai last month as Apple opened its newest retail outlets and shoppers lined up for more than 24 hours for shiny, new iPhone 4s. In a single day, mobile phone carrier China Unicom reported receiving 50,000 advance orders for the latest offering from Apple, only the country's fifth largest smart phone vendor.

So emerge the newest members of the world's middle class, the largest and potentially most powerful group of

consumers the global economy has ever seen. And this trend is just starting.

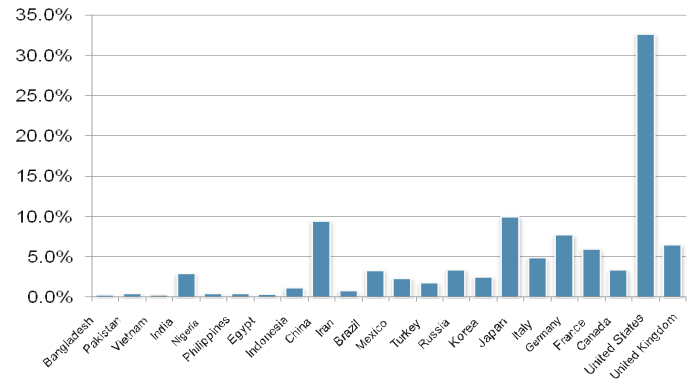
Today, the United States remains the largest contributor to world economic output, and residents of the leading industrialized economies, the G-7, still enjoy a standard of living well above those of their counterparts in the developing world. However, world production and consumption patterns are rapidly changing. Most economists expect GDP growth in developing countries to be much higher than in the G-7 over the foreseeable future (Exhibit 1). Together with higher population growth, this will translate over the next 20 years into close to 2 billion people joining the ranks of the middle class.

In the short term, China's economic managers may succeed in reining in the country's growth rate to prevent overheating. But over the middle to long term, the country's advancing industrialization and productivity — along with similar advances for the world's other populous giant, India — are creating new mass affluence that is certain to shift the supply-demand balance for the world's essential materials — foods, metals, wood, paper, chemicals and fossil fuels.

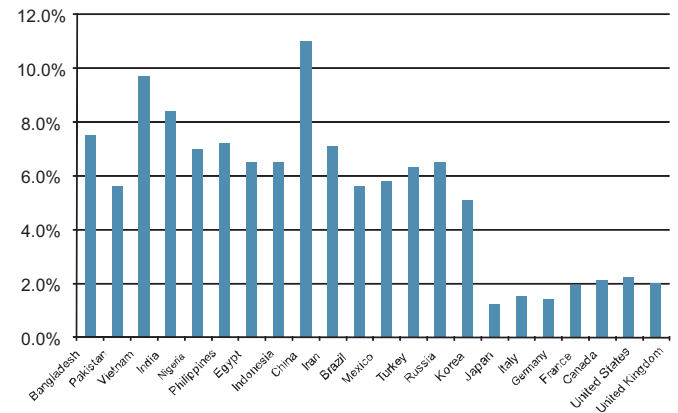
Rapidly advancing industrial output is projected to catapult China ahead of all but the United States in share of world GDP by 2020. By midcentury, China is projected to become the world's pre-eminent producer. The effect of this economic growth will be to elevate many of China's 1.3 billion people from subsistence to relative affluence. Improving living standards for the vast populations of China and India and the rest of the developing economies will more than double the world's middle class over the next 20 years. (cont. page 4.)

### Ex. 1: The Changing Face of World Production

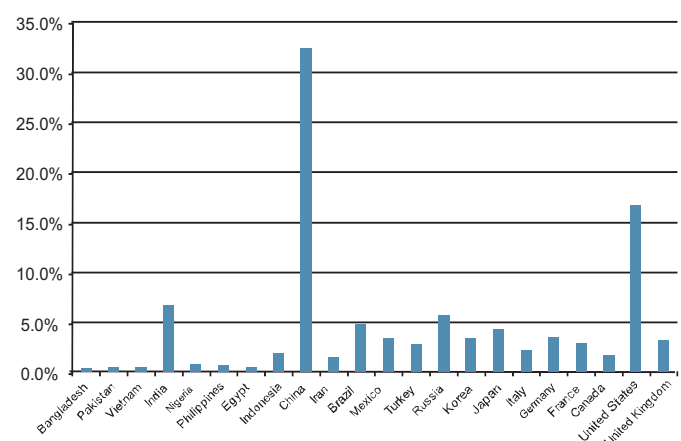
#### 2009 GDP Percentage



#### GDP Growth 2009-2020



#### 2050 GDP Percentage



**China's advancing industrialization** and productivity are creating new mass affluence that is certain to shift the supply-demand balance for the world's essential materials – foods, metals, wood, paper, chemicals and fossil fuels.

Sources: World Bank, UN Population Division, CIA World Factbook, GS Economics Research, Harris Investments Research

## Investing in Commodities for a Brave New World (cont.)

While per capita incomes will continue to trail those of G-7 countries, by virtue of their numbers consumers in developing countries will be a formidable new source of demand for world resources. Population growth in emerging economies promises to continue to rapidly outpace that of the G-7 countries. Over the next 40 years, the U.S. Census Bureau expects the world's population to grow 35%, from 6.9 billion in 2010 to 9.3 billion in 2050. This growth will be very unevenly distributed:

- Developed countries' populations will grow only about 4%.
- Less developed regions will grow about 40% as a result of increasing life expectancy, higher standards of living, and better diets.

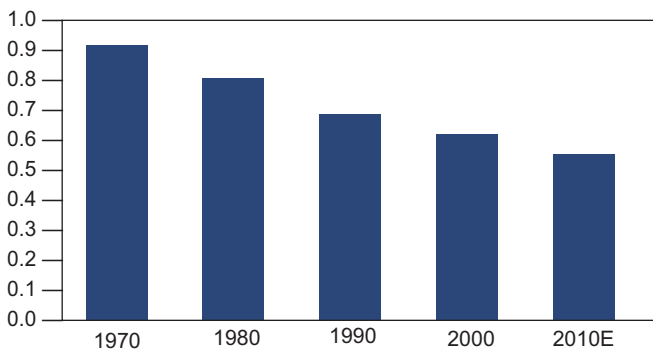
One of the main points of impact will be in agricultural production, because increased consumption of animal protein products typically accompanies new affluence. The resulting increase in demand for grain feed will far outpace the growth in arable land (Exhibit 2). As a result, higher productivity through better fertilizers and seeds is required to increase food production to meet rising demand.

As with farmland, fossil fuel resources are essentially finite. The efforts of industrialized economies to improve efficiency in the use of fossil fuels will do little to offset the effects of emerging economies' rapidly rising demand for oil, gas, and coal.

Consumption of metals, especially aluminum and copper, is highly correlated to rising GDP per capita from the low levels in developing economies because they are required for new housing, appliances, and cars.

### Ex. 2: Acres of Arable Land Per Person

Acres of Arable Land per Person



As of: June 30, 2010

Sources: International Fertilizer Association, Goldman Sachs Research

**Richer diets**, high in animal protein, are a characteristic of consumers' entry into the middle class and pose challenges to the finite nature of agricultural resources.

### So the question becomes: How can investors profit from these trends?

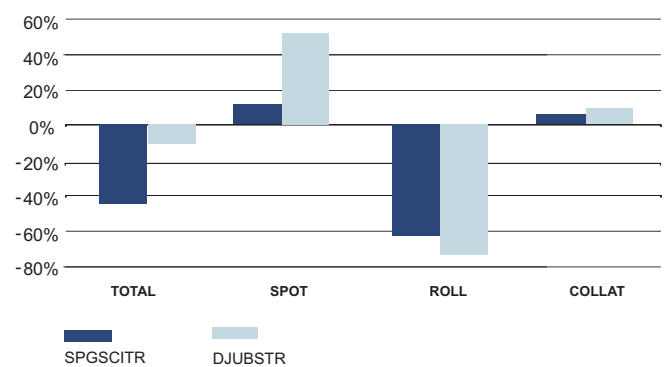
The trend toward increased consumption of commodities is investable in several ways: through the physical ownership and stockpiling of commodities, through positions in commodities futures, and through stock ownership in companies with commodity reserves or with businesses that will benefit from the increased demand for commodities.

Except for a few rare exceptions, such as private equity investments in timberland, the direct ownership of commodities is impractical for most investors. The logistics and costs of transporting and storing commodities quickly erode any gains from price appreciation.

As a result, most investors have chosen to invest in commodity futures. Commodity futures holdings by financial investors increased from US\$15 billion in 2003 to US\$250 billion in mid-2008. During that time the "roll return," the portion of investment return attributable to "rolling over" an expiring position into a new position, has detracted heavily from total returns (Exhibit 3). Also, diversification benefits have decreased in this period as correlation with stocks has increased. (cont. page 7.)

### Ex. 3: Sources of Return – Futures

Sources of Commodities Futures Returns  
5 Years Thru 9/2/2010



As of: September 2, 2010

Sources: Bloomberg, Harris Investments

**Roll down** – The portion of commodities futures returns attributable to "rolling" an expiring futures contract into a new contract has turned negative in recent years, eroding much of the benefit investors have derived from futures.

## Low Rates, Slow Growth, High Yield

The current economic environment presents formidable obstacles for investors who have calculated their past contributions to savings based on long term, asset class returns that aren't holding true. GDP growth in the developed world is anemic; rates of unemployment are high and enduring; and concern over disinflation — or the dreaded deflation — has governments on high alert. In this environment, benchmark interest rates are likely to remain at historic lows, and expectations for equity market returns remain both modest and volatile. Whether it's a “new normal” or just a return to fundamental reality, the risk that investors will fail to meet their long run obligations with traditional asset classes is creating much anxiety.

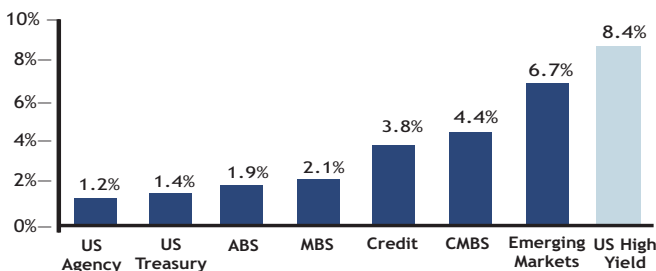
The hunt for yield is on (Exhibit 1). With U.S. 10-year government bonds offering a 2.50% yield, and investment-grade corporate bonds offering a mere 185 basis points in spread on top of that historically low base rate, it's going to be difficult to meet long term return targets with a core investment-grade bond portfolio<sup>1</sup>.

The U.S. stock market isn't looking much better these days, and it's not difficult to find comparisons being made in economic circles to the lost decade in Japan. Over the past 10 years, returns on the S&P 500 were -1.81%, while returns on the MSCI All Country World Index were 0.62%<sup>ii</sup>. Historical returns do not provide a lock on the future, but with muted GDP growth forecasts for the next few years, investors are hard pressed to find optimism in equities.

So where does a risk conscious investor turn to for yield without taking on undue duration risk, adding volatility, or moving U.S. dollars offshore?

### Ex. 1: The Hunt for Yield

#### Yield by Fixed Income Asset Class



As of: August 31, 2010

**Yield of dreams** – Fixed income securities from Treasuries to investment grade corporate bonds offer relatively low coupon rates. By comparison, high yield bonds hold greater potential for return both from coupon and capital appreciation.

Sources: Merrill Lynch, U.S. Treasury: U.S. Treasury Master (GOQ0), U.S. Agency: Unsubordinated U.S. Agency Master (G0P0), MBS: Mortgage Master Index (M0A0), ABS: Asset-Backed Securities Master Index Fixed Rate (ROA0), CMBS: CMBS Fixed Rate Index (CMBS), Credit: U.S. Corporate Master (COA0), U.S. High Yield: U.S. High Yield Master II Index (H0A0), Emerging Markets: USD Emerging Market Sovereign & Credit (ID00).

### Attractive long run risk/reward characteristics

Over the past decade, the U.S. high yield market returned 7.30%<sup>iii</sup>, very close to the assumed long run return on equity portfolios, but with considerably less volatility. Risk is mitigated by high yield's fixed coupon rates, coupled with a superior position in the capital structure versus equity, with some bonds and loans backed by secured claims. Even ignoring the opportunity for price appreciation, a relatively conservative high yield portfolio offers a contractual coupon and yield averaging 8.40%<sup>iv</sup>.

As a testament to the relative value being found in the high yield space, fund flows into high yield mutual funds set a record of \$32 billion in 2009; year-to-date flows in 2010, at \$6.3 billion, are on track to be the next best year since 2003<sup>v</sup>. With all that cash flowing into the asset class, yields and spreads have made a remarkable tightening rally, but still offer some of the best absolute — and risk-adjusted — return prospects out there (Exhibit 2). (cont. page 6.)



**Lori Marchildon, cfa**  
Portfolio Manager

HIM Money, Inc.

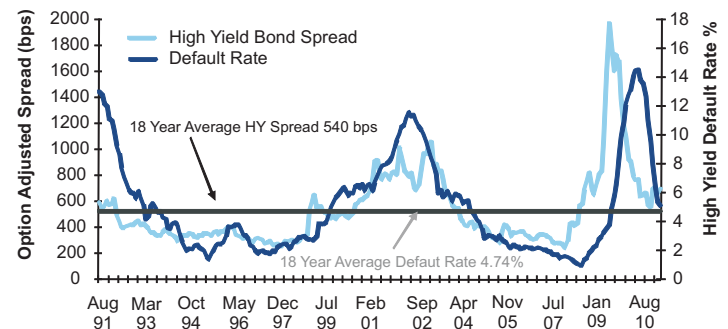


**Jason Anderson, cfa**  
Director, Senior Credit Analyst

HIM Money, Inc.

### Ex. 2: Improving Fundamentals

#### High Yield Spread and Default Rates 1991 -2010



**Healthy choice** – Company balance sheets have improved markedly, the new-issue market for high yield bonds has been vibrant, and a large cross section of high yield issuers has taken the opportunity to push out maturities by refinancing short-term paper at attractive yields.

Sources: Merrill Lynch, Moody's. Notes: As of August 31, 2010. Default Rate is Moody's Trailing 12-month U.S. Issuer Based Speculative Grade Default Rate. Spread is Option Adjusted Spread, Merrill Lynch High Yield Master II Index.

## Low Rates, Slow Growth, High Yield (cont.)

### Balance sheets: Marked improvement from pre-2008

While strong economic growth is required for equity markets to outperform, modest growth can sustain a diversified portfolio of sound high yield bonds. Fundamentals in the high yield market have turned positive, leading to an expectation of “coupon clipping” returns. Company balance sheets have improved markedly from the pre-2008 era of excess leverage. The new issue market for high yield bonds has reopened for business, and a large cross section of high yield issuers has taken the opportunity to push out maturities by refinancing short term paper at attractive yields.

Companies have also been cutting costs aggressively to preserve margins and provide the liquidity required to reduce overall leverage and sustain free cash flow generation. Numerous companies are also holding on to high cash balances that they had built up to weather the risk that financial markets would not be open for working capital or refinancing needs.

These excess cash balances, if not invested in value-added capital projects or distributed to equity holders as dividends, present further opportunity for deleveraging once a greater sense of stability is entrenched. In line with these positive developments, the default rate for high yield bonds has fallen considerably from the highs experienced in middle to late 2009. Further, we expect that high yield defaults will continue to trend downward in light of improved credit metrics and the accessibility of refinancing in the high yield market.

### Well positioned in recovery periods

Based on historical multi-asset class analysis, evidence supports the contention that high yield tends to outperform equities in periods of recovery<sup>i</sup> (Exhibit 3). The empirical observations fit with the intuitive logic that we've been applying to this point: Equity needs growth to drive price appreciation, while high yield pays an attractive contractual coupon as long as the bonds remain outstanding. Looking at the past three investment cycles since 1990, high yield has performed in the middle to upper quartile of asset classes in the two to three years following recessions.

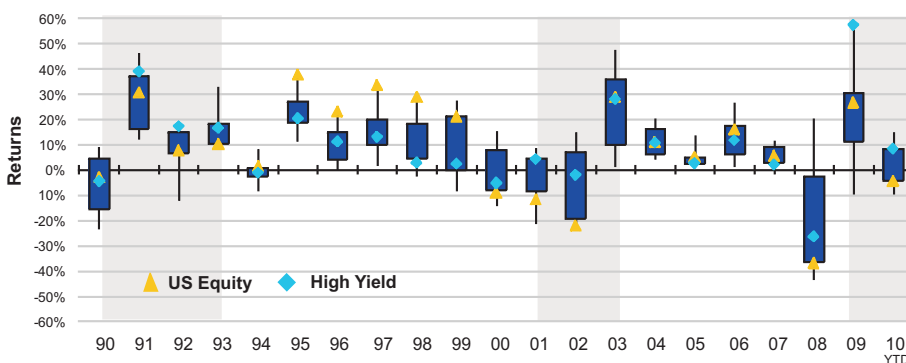
If these data trends continue, and apply to the current cycle, investors can capture coupon-plus, equity topping returns with the downside capital protection of a fixed income product.

At a time when it's hard to find options for absolute returns sufficient to exceed long term targets, a strategic allocation to high yield may be worth a closer look. However, it is imperative that investors choose the right high yield asset manager, one with the right combination of active management experience and a disciplined investment decision making process. With the right manager, history shows that high yield investors can earn excess returns with low volatility — not a bad solution in this environment. ▲

i Bloomberg, Merrill Lynch Corporate Master Index (C0A0), as of 9/22/2010  
 ii S&P 500 Index, MSCI All Country World Index (Gross Dividends), 10-year return through 8/31/2010  
 iii Merrill Lynch U.S. High Yield Master II Index, as of 8/31/2010  
 iv ibid  
 v AMG Fund Flows, CorpHigh Yield through 9/8/2010  
 vi Bloomberg, S&P 500 Index, Merrill Lynch U.S. High Yield Master II Index (H0A0). Note: YTD is as of 8/31/2010

### Ex. 3: Positioned for Recovery

Relative Returns 1990-2010



As of: August 31, 2010

**Upward participation – Looking at the past three investment cycles since 1990, high yield has been a mid-to-upper-quartile performer among asset classes in the two to three years following recessions.**



Sources: Bloomberg, Merrill Lynch, U.S. Equity: Barclays Aggregate, S&P 500 Index, Russell 2000 Index, MSCI EAFE High Yield: U.S. High Yield Master II Index and U.S. Treasury, Current 10-year. Note: YTD is as of August 31, 2010. Grey shaded area represents periods of negative GDP growth and the subsequent two to three years that proxy the recovery period.

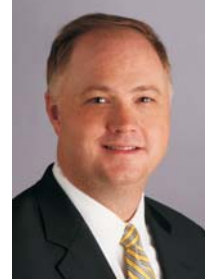
## Sharpen Your Pencil, Stay the Course

In short duration fixed income investing, it remains prudent for investors to stay sharply attuned to the federal funds rate, economic commentary, Libor funding, and the overall supply and demand conditions. However, as we are witnessing the lowest yielding investment curve in U.S. history, it is also important to remain diligent in reviewing all investment factors. Unfortunately, atypical conditions have caused institutional investors to abandon well-diversified investment strategies, which led them to stray from original goals and objectives. At times like the present, we believe that reviewing investment policy is of the utmost importance and we encourage investors to stay mindful that risk remains, regardless of diminishing income.

As cases in point, we consistently meet with investors wishing to revisit past decisions. Our efforts range from creating guidelines for new investors to revising technical scenario analyses for seasoned investors. The growing sense that conditions are here to stay (much like Japanese interest rates since March 1999), is prompting many investors to rework their goals. The result is not necessarily the use of longer duration products, or the inclusion or exclusion of different asset classes, but more an exercise in the escape from futility. By this, we specifically look at all alternatives to generic money market funds. As we have held for years, unless you truly need all of your funds tomorrow, paying for other investors' liquidity should be the last option you exercise. We continue to work with our institutional investors to explain the choices available — the costs, the risks associated with each decision, and where the optimal return can be realized. This all starts with continuous dedication to one factor, cash flow forecasting.

Overnight interest rates and money market averages yield in the low 20 basis points. In this environment, the credit sectors of mortgage and asset backed securities, as well as corporate debt, can provide additional income to portfolios. Nowhere has this been more readily recognized and exercised than within the government money market universe, where year-to-date outflows now total almost 23%. Prime money market funds also continue to decline with a more modest level of redemptions, at almost 8%. With the Federal Reserve on the sidelines possibly until late 2011, Treasuries are unlikely to be the source of additional yield for some time. The Fed's absence will support continued curve flattening across much of the money market universe. With October traditionally a large maturity month for many financial institutions, we look for high levels of corporate issuance to continue as a lack of supply and low yields provide a cheap source of funding.

The consistent theme in all sectors appears to be the same; low yields are here for a while. In these conditions, due diligence, credit analysis, and appropriate sector rotation need to be continuously performed. We urge all investors not to settle for status quo, stay diversified, remain optimistic, and seek expertise to maximize goals. ▲



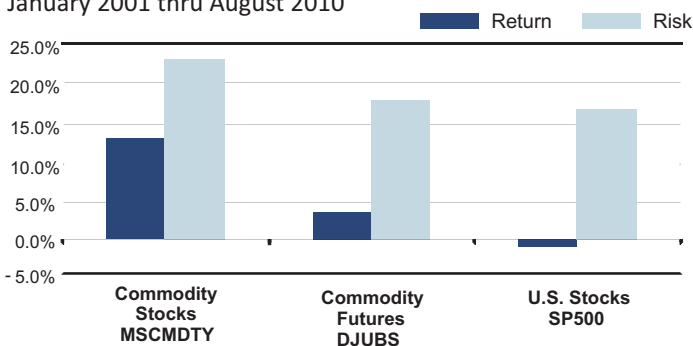
**Peter J. Arts**  
Managing Director,  
Fixed Income

## Investing in Commodities for a Brave New World (cont.)

### Ex. 4: Risk/Return Profiles of Commodities

#### Comparative Risk and Return

January 2001 thru August 2010



As of: August 31, 2010

Sources: Bloomberg, Harris Investments

Investing in commodity stocks has produced superior returns and a better risk-reward result than investments in commodity futures.

The remaining alternative, investing in the stocks of companies with direct commodity exposure, has produced superior returns and a better risk-reward result than investing in commodity futures (Exhibit 4).

With developing economies' share of world output rapidly increasing and with the growth of their middle class populations accelerating, the impact on demand for commodities will be significant. To benefit from this strong, secular trend investors are well advised to consider participation through commodity equities rather than through commodity futures. ▲

## Benchmark Performance Summary

As of September 30, 2010

Benchmark	3 Month	Year to Date	1 Year	3 Year	5 Year	10 Year
S&P 500	11.29%	3.89%	10.16%	-7.16%	0.63%	-0.43%
Russell 1000®	11.56	4.41	10.75	-6.80	0.85	-0.21
Russell 1000 Growth®	13.00	4.37	12.66	-4.36	2.06	-3.44
Russell 1000 Value®	10.13	4.50	8.91	-9.39	-0.49	2.59
Russell 2000®	11.29	9.11	13.34	-4.29	1.60	3.99
Russell 2000 Growth®	12.82	10.22	14.78	-3.74	2.35	-0.13
Russell 2000 Value®	9.72	7.94	11.84	-4.99	0.74	7.72
Russell Microcap®	7.81	7.94	7.44	-8.49	-2.10	4.07
MSCI EAFE (Gross Div)	16.53	1.45	3.71	-9.06	2.44	2.97
MSCI All Country World Index (Gross Div)	14.45	4.02	8.93	-6.97	2.92	2.12
MSCI All Country World Commodity Producer Sector Capped Index (Gross)	20.62	0.37	12.37	-3.93	10.00	N/A
Barclays Capital Aggregate	2.48	7.94	8.16	7.42	6.20	6.41
Barclays Capital Inter Govt/Credit	2.76	7.44	7.77	6.94	5.95	6.05
Barclays Capital Long Govt Credit Bond	5.85	16.69	13.61	10.24	7.35	8.36
Barclays Capital Municipal Bond	3.40	6.83	5.81	6.04	5.13	5.73
Barclays Capital 3-15 Blend Muni	3.12	6.28	5.79	6.58	5.43	5.62
Merrill Lynch BB/B Constrained	6.74	11.58	16.78	7.58	7.31	7.27
Merrill Lynch 1-3 Govt/Corporate	0.92	2.88	3.26	4.53	4.63	4.55
Merrill Lynch 90 Day T-Bill	0.04	0.08	0.13	1.13	2.60	2.55
Merrill Lynch 6 Month T-Bill	0.10	0.28	0.36	1.93	3.15	2.95
30 Day T-Bill	0.04	0.08	0.09	0.77	2.34	2.26

Sources: Russell, MSCI, Barclays Capital, Merrill Lynch and Bloomberg

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