



Commonwealth Patriot Trust Mid Year Update -- 2010

Dear Investor,

Over the past couple of months, capital markets have again begun to exhibit increased volatility, punctuated by several manic swings of bullish and bearish sentiment. As well, the recent pattern of lower market index highs followed by lower market lows would indicate that investors are becoming particularly sceptical as to the course of the alleged economic recovery. What began as a year of cautious optimism prompted by upbeat corporate earnings and an improving U.S. employment picture, has since been supplanted by a darkening mood of concern for the sustainability of the nascent recovery. A steady diet of unsettling statistics indicates that the American recovery may have stalled and in fact may be slipping back into recession. There is a growing realization that the global fiscal mess brought on by the western world's past credit excesses has not really been dealt with and that a long hard road to the problem's resolution lies ahead. Through this six month period Patriot Trust has charted relatively stable, albeit modest, overall 2.9% portfolio growth, which now looks attractive when compared with the almost universally negative results posted by most of the world's major equity markets over the same period. Patriot's comparative benchmark, the broad based TSX S&P Composite Index, has outperformed a majority of the world's exchanges during the first half of this year, yet still registered a negative 3.85 % return. And as a result of recent sharp global market reversals, major indexes such as the U.S. Dow Jones (-6.27 %), the European Stoxx (-13.20%), and Shanghai Composite (-26.81%) are now all back into deep negative territory year to date. As I write this investment letter, the sentiments of economists, financial pundits, and other students of the economy, are becoming markedly more gloomy. Worrisome arguments are now being forwarded that there now exists at least a 50% probability that America will regress into double dip recession and that the EU, with the possible exception of Germany, could experience the same. In fact, a number of sovereign debt issues in Euro land remain so onerous, that there is a very real concern that the future of the world's largest common currency union as presently constituted, may be in jeopardy. In fact the Bank of International Settlements, a central banker to the central bankers of the world, has warned that twelve of the world's most influential economies are in need of drastic measures to avoid a complete fiscal meltdown. By the end of next year, the average public debt of these countries will have risen from 73% of GDP in 2007 to more than 105%. Extreme examples include the U.S., with a debt to GDP forecast of 150%, Britain 200% and Japan 300%. Since the United States and the European Economic Community comprise almost 50% of global economic activity, the outcome to the foregoing problems will greatly impact all nations.

After almost three years of 'bunker style' portfolio management, there is a yearning to put recession style portfolio structuring behind us, to reduce many of the Trust's counter cyclical positions, and re-invigorate the

portfolio with progressive, well run growth companies that will likely profit handsomely from any sustained global recovery. However, more of the 'same old' defensive investment strategy appears the prudent course. Indeed it is likely that we may experience several more years of anemic economic performance before the balance sheets of both governments and consumers are restored to health. So, although we are pleased that Patriot Trust has managed to post superior returns since the onset of the market meltdown three years ago, (+ 29.6% cumulatively to date vs -18.78% for the TSX Composite), we would welcome a more gentle investment climate characterized by modest volatility and positive sentiment.

When one considers the nature of the policies that have been enacted to pull the global economy out of deep recession, it really comes as no surprise that 2010's fragile recovery appears to be in jeopardy. What we have witnessed over the past two years resembles a giant shell game, whereby the crushing debt obligations of the banking industry, certain 'too big to fail' corporations and consumer credit excesses, have merely been transferred from the private sector to the public sector. Massive government bailout and stimulation spending, dignified with the label of Keynesian policy, has created neither wealth nor a platform for prosperity over the longer term. What we now have is our southern neighbour and the EU, both shouldering massive government straight-jackets of debt that will limit fiscal flexibility and which ultimately can only be addressed with a combination of onerous tax increases, 'quantitative easing' (meaning paper currency printing), and deep cuts to social programs. The problem will at best take several years to fix, and at worst may culminate in the bankruptcy of a number of countries; some declared, some not. To have gotten ourselves into this credit situation in the first place, a corollary shell game has also been taking place for more than a decade. This has been the abrogation of much of our goods and services producing capability to Asia; now considered the world's manufacturing workshop. The wherewithal to pay for all of this, and therefore continue to enjoy a standard of living beyond our means, has been to avail ourselves of the very accommodative credit provided by China and its Asian neighbours. The result has been a role reversal from the traditional practice of the developed world financing the needs of the emerging world, to that of the emerging world assuming the role of bankers for the West. Until recently, all of this has appeared to work extraordinarily well, with product demand from the West enabling Asia to build a modern society and an impressive infrastructure while also providing much of rest of the world with a standard of living higher than would otherwise be possible. However; it appears that the time to pay the Piper has arrived. China has U.S. dollar reserves now exceeding a trillion dollars and is understandably uncomfortable with the economic underpinnings of the dollar. In addition, indications are that China's meteoric growth rate is now decelerating. This does not bode well for global economic activity, particularly for the large commodities producers such as Canada.

All of this continues to shape the structure of Patriot's investment portfolio. For the past three years or more, we have steered clear of the banking sector and continue to do so. This has proven to be a foregone opportunity for the Trust during the past year or so, as the banking industry has rallied strongly from its lows, however now does not appear to be the time to become positioned. Although the Canadian banking sector is acknowledged to be among the soundest in the world, at this point we consider it to be fully priced within the context of the industry's historical trading multiples, and in view of an anticipated softening housing market and associated mortgage lending activity. And because of the slowdown of equity markets, the Banks' investment banking divisions are also likely to experience reduced trading, M&A and new issue activity.

Because of our 63 % gross weighting in Canadian securities, with no exposure to Canadian banks, it follows that Patriot's portfolio remains solidly oriented to the commodities sector, with a 28% weighting in energy related securities, a 15% exposure to base metals mining, and a more modest 2% position in forest products

companies. Although there are legitimate concerns for the short term prospects of commodities producers, it remains our conviction that attractive supply-demand mechanics make many companies look attractively valued, particularly those which are engaged in the production of copper, oil, metallurgical coal and lumber. With a more intermediate term outlook, we believe that positioned Canadian producers such as Teck Corp., Encana, Baytex Energy, and Acadian Timber should have a place in the portfolio now. The fact that these companies have a large percentage of their operations in politically safe and stable jurisdictions such as Canada is an added plus. As for the specific commodities mentioned, the pricing of 'Dr. Copper' is generally viewed as a bell weather of global economic health. However, pricing has managed to hold up surprisingly well during the turbulence of the past while, largely because of what looks to be a shortage of new large scale copper development projects on the books. It typically takes seven to ten years to take an ore body from design inception through to production. As for energy, (specifically oil and not natural gas), we believe that a floor price exists not far from the current levels of US \$72.00 per barrel, for it is in this pricing range that an adequate rate of return can be realized by most oil E&P's while at the same time provide for the risks and escalating costs of developing ever more remotely located and technologically challenging reserves. Metallurgical coal, used in steel production, is also attractive because of its principal geographical location and relative scarcity. Almost 80% of the world's reserves are located in Canada and Australia. As for lumber, it is no surprise that prices are severely depressed, given that U.S housing starts are now reporting at thirty year lows. It's anybody's guess as to when a meaningful housing turnaround takes place, but when it does, supply shortages are almost certain, particularly for softwoods which are used extensively in building construction. The impact of the devastation caused by the Asian mountain pine beetle to the western forests of British Columbia, Oregon, and Washington state, will only be fully recognized when construction activity returns to more normal levels.

The more counter cyclical and defensive components of Patriot's portfolio continue to be precious metals at approximately 7.5%, senior pharmaceutical and health related companies at 8.8% and telecommunications at almost 10%. Not only do these sectors provide important portfolio stability, but with the exception of precious metals, also provide generous dividend yield support. And as has been the case for the past couple of years, portfolio downside protection is enhanced through the use of equity index shorts. At quarter end these instruments totalled 31% of the portfolio's gross valuation which has in turn provided an overall net beta weighted equity market exposure of +55%.

We are therefore comfortable that the portfolio is properly positioned to withstand the shocks of substantial market volatility without unduly sacrificing the upside potential that we believe exists for the many excellent growth and value companies in the portfolio.

As always, I would be happy to discuss any matters relating specifically to your portfolio or to the contents of this letter. I can be directly reached at 416 361-1823 or at alex@jcclark.com.

Respectfully yours,

Alex Davidson
Portfolio Manager

